VOL. 68 No. 2 *February* 1956

# THE CANADIAN CHARTERED ACCOUNTANT

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

**Inventory Valuation**

**Spotlight on Prospectuses**

**Canadian Wheat Board Operations**

**Professional Developments**

ACCOUNTING RESEARCH • THE TAX REVIEW • CURRENT READING
ADMINISTRATIVE ACCOUNTING • STUDENTS DEPARTMENT

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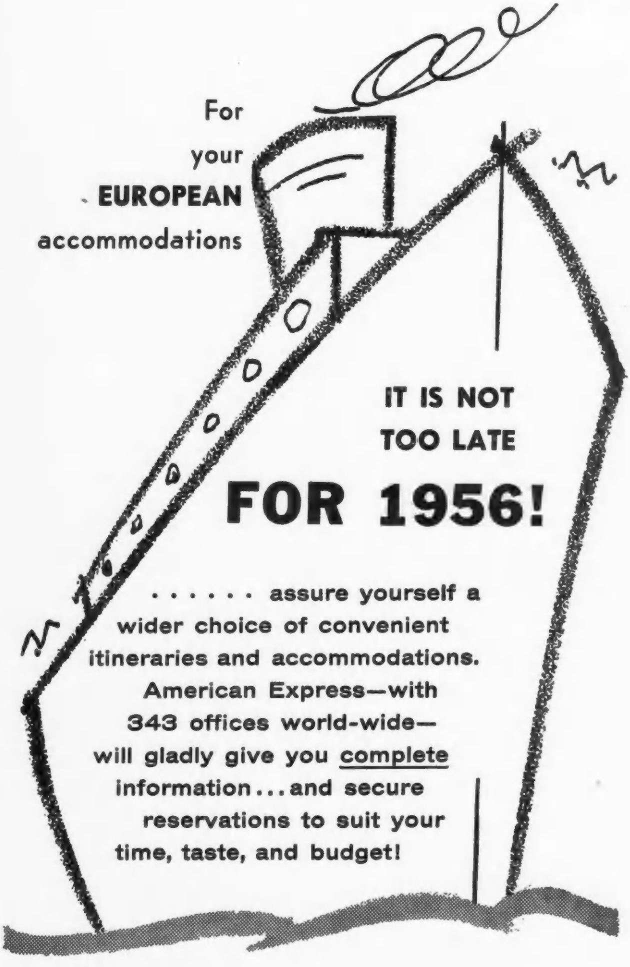

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*THE CANADIAN*

# *CHARTERED ACCOUNTANT*

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## IN THIS ISSUE

**C. E. GORDON EARL, C.A.**

Although the buying and selling of grain is a very important feature of the Canadian economy, many business men are probably unfamiliar with the organization that is so closely related to its marketing. In recent years unprecedented quantities of Western Canadian grain have necessitated a continuous review of marketing methods, and Gordon Earl's article "Twenty Years of Canadian Wheat Board Operations" outlines the role of the Board in considering the most suitable ways of meeting both domestic and export commitments.

The magnitude of the Board's operations may be seen in the fact that in 1954 it employed 730 persons in offices located at Winnipeg, Calgary, Vancouver, Washington, D.C. and London, England. The author notes that for the same period its total administrative and general expenses were slightly under $2.8 million. In disclosing these figures, Mr. Earl points out that throughout the years of the Board's operations, the per bushel cost of administrative expenses has never exceeded two-fifths of one cent per bushel.

Formerly a partner in the firm of Millar, Macdonald & Co., Winnipeg, Mr. Earl is comptroller of the Canadian Wheat Board, a position he has held for the past eight and a half years. He is a member of the Institute of Chartered Accountants of Manitoba and at present serves on the Council of that Institute.

**INVENTORY VALUATION**

*Royal Commission Report*

Probably the most important chapter, so far as the accountancy profession is concerned, of the Royal Commission Report on the Taxation of Income and Profits is that dealing with inventory valuation. The chapter is an excellent summary of the role of inventory valuation in profit calculation and it is especially recommended to our readers.

Of particular interest is the recommendation in Appendix 2 that British tax payers be allowed to use any one of a number of methods, including a modification of the base stock method of valuation. Under the proposed modified system any increase in inventory during a year is priced at average cost and added to the opening inventory. A new average is then struck. If a reduction in stock occurs during any year, it is withdrawn from inventory at a price based on the new average rather than at the cost of the most recent additions, as will be done under the *Lifo* method.

The reasoning underlying the recommendations in the Royal Commission report is in striking contrast to the recent decision of the Privy Council in the *Anaconda American Brass* case, which seems to have closed the *Lifo* method to Canadian tax payers. We hope to arrange a discussion on this topic for an early issue.

**EDITORIAL**

With the increased burden of taxation in recent years and the growing complexities that confront corporations and individual taxpayers, it seems well to review the place of our profession in the taxation field. L. C. Frewin, in this month's editorial,

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outlines the function of the accountant and also makes it clear when the services of the lawyer should be used.

It might be said that the Income Tax Act is, in part, an endeavour to interpret in legal language what the income of a business is according to commercial practice and sound accounting principles. Since only income is to be taxed, it is important that it be accurately determined in accordance with the terms of the Act and it is at this juncture that conflict arises.

L. C. (Bob) Frewin has been keenly interested in taxation matters since 1940 when he organized the firm of Ross, Frewin & Company in Montreal. Ten years later it was merged with Peat, Marwick, Mitchell & Company and Mr. Frewin became a partner of that company. He has been a member of the Institute of Chartered Accountants of Quebec since 1928 and was on its Council for two years. In 1953 and 1954 he served on the Taxation Committee of the Canadian Institute and is currently its chairman for a two year term.

## FORTHCOMING FEATURES

*Accounting for the B.C. Lumber Industry*
R. R. KEAY AND D. J. KELSEY

*The Case for Social Accounting*
J. E. SMYTH

*Have the Railroads Had Their Day?*
J. A. McDONALD

*A Budget for Saskatchewan Road Transport*
F. G. COPITHORNE

*Capital Gains Re-examined*
RALPH LOFFMARK

# NOTES AND COMMENTS

## American Reports Surveyed

American corporate financial statements are becoming increasingly streamlined and informative according to a survey just published by the American Institute of Accountants of the annual reports of some 600 typical corporations.

The latest survey shows that for fiscal years ending between May 1954 and April 1955, 41% of the reports used a "single-step" income statement compared with 21% when the survey was started in 1946, 74% showed financial information on a comparative basis compared with 41% in 1946, and 80% supplied additional financial information beyond that included in the audited statements compared with 67% in 1950. The title "balance sheet" gave way to the more modern "financial position" or "financial condition" in 20% of the reports as contrasted with 3% in 1946, while the income statement was described as "income" or "earnings" by 79%, with only 13% adhering to the older term "profit and loss". Increasing attention to employee benefits was reflected in the mention of pension and retirement plans by 58% and of stock options by 34%.

## Summer School in Accountancy

The School of Commerce at McGill University will hold its second summer school in accountancy during July 1956. The term will run four weeks from Monday, July 2 to Friday, July 27, and lecture periods will be from 10 a.m. to 12 noon and from 2 p.m. to 4 p.m. daily. Two courses of study will be offered, one for the intermediate and the other for the final uniform examination in chartered accountancy. The tuition fee for each course will be $135, the same as last year although the course is one week longer. It is a requirement that all students must be in residence at the university throughout the period, and any information regarding residence fees may be obtained by applying to the Director of Extension Courses at the university. The school will be under the supervision of Professor Kenneth F. Byrd, M.A., B.Sc.(Econ.), C.A.

## U.K. Tax Digest

The Federation of British Industries has recently published a digest of the reports of the U.K. Royal Commission on the Taxation of Profits and Income and of the Millard Tucker Committee. Copies may be obtained from the Federation at 21 Tothill Street, London, SW1, for the price of five shillings.

## AIA Research Bulletin No. 45

The Committee on Accounting Procedure of the American Institute of Accountants has just issued its Accounting Research Bulletin No. 45 dealing with long-term construction-type contracts. It sets forth the advantages and disadvantages of the

*Continued on page 92*

Continued from page 90

two accounting methods commonly adopted by contractors, namely the percentage - of - completion method and the completed-contract method. It gives preference to the former, provided that estimates of costs and extent of progress toward completion of the contract are reasonably dependable.

**Clerical Workers Salaries Up**

According to figures released by the National Office Management Association, clerical workers in Canada averaged $1.00 a week more pay in 1955 than in 1954. Best rates were paid in Niagara Falls, Ontario, with Windsor, Ontario in second place. The city showing the greatest increase in the last 10 years was Calgary, Alberta where salaries in 1955 were 92% higher than they were in 1945.

**Changes in Legislation**

The Speech from the Throne on January 10 forecast a considerable program of legislation during 1956. Included is a revision of the Succession Duty Act, which may be examined by a parliamentary committee. Another step which has been indicated though not defined in the speech is the revision of the Excise Tax Act. A committee of businessmen and government officials is examining this law at present and is expected to recommend a number of changes.

**Income Tax Briefs**

Recent submissions on the Income Tax Act and Succession Duty Act have been made to the Ministers of Finance and National Revenue by the Canadian Manufacturers Association and the Canadian Chamber of Commerce. One of the Chamber's recommendations which is of particular interest to accountants is that the right to deduct pension fund contributions be granted to the self-employed as well as to employees for whom approved plans are not available. Another is that the Income Tax Appeal Board be enlarged to provide for the appointment of professional accountants as members of the Board.

**Chair in Financial Accounting**

The Ford Foundation has made a grant of $625,000 to Columbia University Graduate School of Business to promote a three-way program in the fields of financial accounting, international business and faculty research. Of this grant, $250,000 will be used to help endow a professorial chair in financial accounting.

**C.I.C.A. Spring Meeting**

The Executive and Council of the Canadian Institute of Chartered Accountants will meet during the last week of May at The Briars, Jackson's Point on Lake Simcoe.

**C.A.'s and Lawyers Prepare Brief**

A joint meeting of the Taxation Section of the Canadian Bar Association and the Taxation Committee of the C.I.C.A. was held on January 19 to prepare the brief which the two associations will present to the Ministers of Finance and National Revenue in February. Chairmen of the two committees are Henry White, Q.C. and L. C. Frewin, C.A.

**Patron of Accountants**

On January 1 Pope Pius XII declared the apostle and evangelist St. Matthew to be the patron saint of accountants.

# Editorial

## THE ACCOUNTANT IN THE TAXATION FIELD

During the 1917 session of Parliament the Income War Tax Act first came into existence in Canada and imposed a tax of 4% on the incomes of corporations in excess of $3,000. Since that date the trend has been toward higher and higher rates of tax, and this increasing burden has brought about the important function of the accountant in the field of corporate taxation. As the weight of tax has become heavier, it has had two effects: first, it has led to a more complex formula for determining taxable income throughout each succeeding Income Tax Act and secondly, coupled with this, it has engendered a need for skilled accounting advice in applying the terms of the pertinent Act to the actual facts of each taxpayer.

The professional accountant has in fact since 1917 had to read, learn and inwardly digest the various Tax Acts in an endeavour to interpret their effect on the affairs of his clients.

It is essential for the orderly conduct of a corporation's business that its liability for income tax be ascertained at the close of its fiscal period as quickly and as accurately as possible. This determination is a responsibility of the corporation's auditors.

The corporation's income tax returns are reviewed annually by officials of the Income Tax Department to satisfy themselves that the reported liability is correct, and in the majority of cases the professional accountant is fully familiar with the contents of the return and the basis on which it was prepared. It is also the practice of the Income Tax Department to have their assessors examine the corporation's records to verify the reported taxable income and the resultant tax liability. These on-the-spot examinations are not always made annually, but usually occur before a corporation of any size receives its re-assessment, if any, which denotes either that there is a further tax liability or that a refund of tax is due. While assessors are examining the accounts, they may ask questions as to the

determination of taxable income on which there are differences of opinion. When all the disputed items have been assembled, the corporation will usually arrange with its auditors to discuss these items with the assessors and, if possible, reach an agreement as to the amount of the taxable income. In the majority of cases the discussion results in agreement as to the corporation's tax liability.

There are, of course, times where the divergence from the assessors' opinion is so great that the unsettled matters are referred to higher officials in the District Office. At this point, the professional accountant may be asked to prepare a complete summary of the facts related to the problems and to study the applicable sections of the Income Tax Act. Arrangements are made with a senior official of the Tax Department in the District Office for a meeting to discuss and present the corporation's views. Frequently, at such meetings, the problems are resolved.

If the problems persist even at this level, there is still the possibility of discussions with the Deputy Minister of National Revenue (Taxation) or his assistants in Ottawa. At this stage, more is known of the Department's views so that the original presentation can be amplified to meet points that have arisen in the discussions.

In Ottawa the problem is argued freely and openly and often a satisfactory solution or compromise is reached. When, however, the Department is not prepared to accept the arguments of the taxpayer, the normal procedure is to wait for the receipt of the reassessment notice.

If the corporation decides to appeal the re-assessment, a notice of objection and reasons for appeal are prepared and filed preferably by the corporation's lawyer in consultation with the professional accountant.

The taxpayer or any designated representative may appear before the Tax Appeal Board and argue the validity of a re-assessment, but it is advisable to retain the services of a lawyer. The professional accountant can best serve his client at this time as an expert witness because of his considerable experience in the accounting and commercial fields and his knowledge of the application of the Income Tax Act and Regulations in the determination of taxable income.

# Inventory Valuation

**Recommendations from the final report of the Royal Commission on the Taxation of Profits and Income**

THE PROBLEM of the proper treatment of stock in trade in the accounts that record the trading profits of the year is usually discussed as another instance of the fact that a rising monetary cost of replacing business assets results in distorting business profits so long as they are computed on the basis of historical cost. It has therefore been put to us as one branch of the argument that a true conception of business profit requires the allowance of a reserve against current receipts in respect of the enhanced cost of their replacement. But we came to the conclusion, after analyzing the problem, that the analogy is likely to mislead and that, so far as taxation is concerned, the considerations that are important for one case are not the considerations that are important for another.

It is useful to be clear what the problem is. A trader operates with stock in trade. His business revenue consists primarily of his receipts from the disposal of that stock. Against those receipts there must be set the costs appropriate to the stock disposed of before any figure of profit can emerge. Those costs cover not only the costs of acquisition and disposal but also, if the trader processes or manufactures his stock, the cost of process or manufacture, including in that cost the cost of any material consumed during the operation.

Since, however, it is necessary that a trader should always have in hand an adequate supply of stock, though not at any unvarying level or volume, there is no obvious way of determining what is the cost appropriate to any particular sale of stock. It has simply been drawn from his pile or pool. Profits, whether for taxation or otherwise, are normally struck on the basis of annual rests. Therefore at the opening of the accounting period there will be stock in hand, the cost of which will have been carried over from the previous year; there will be stock acquired from time to time during the year, previous to the date of sale of the parcel in question; and there will be other purchases during the remainder of the year and, at the close, some volume of stock in hand, itself to be carried over to the succeeding year at an appropriate cost. All the different parts of this floating supply may have been acquired at different levels of price.

The natural way of meeting this complexity is to make some general

assumptions and then to assign cost to particular sales on the basis of those assumptions. It is not as if it were possible to identify the actual cost of the actual item disposed of, except in a few special cases. A jeweller, a picture dealer, some retailers, must match their receipts to the actual cost of acquiring the object sold. But in the majority of cases that would either be impossible or would be possible only with an expenditure of time and labour in accounting records so great as to make the exercise absurd in practice. The general assumption hitherto accepted in this country is that stock is sold in the same order of priority as the order of the dates at which it was acquired. Thus the trader is treated as selling the parcel of stock which has been longest in his hands at the date of sale, and the cost appropriated to it is the cost that has been longest in his books.

We do not suppose that this assumption, however convenient, derives its validity from any peculiar correspondence with the trader's physical operations. Strictly speaking, it assumes an order that is likely to be observed only in the case of perishable goods, and only then if all consignments were equally perishable. On the other hand, where successive purchases of stock go into store or pile, the chances are that in practice the more recent arrivals are the earlier drawn upon. In other cases, as for instance in the case of liquids, consignments may become so mixed as to be inextricable in any historical order.

We must make a second qualification. While the system of appropriating costs on the basis of "first in, first out" (which has now come to be known as *Fifo*) is the generally accepted one in this country, it is not, and probably never has been, the system universally employed. We have already referred to the necessity of appropriating to some articles their actual individual cost – the "unit cost" system. Then there is the "average cost" system, under which the book cost of the opening stock is averaged with the cost of goods added during each succeeding period after deducting consumption at the average price, the periods being determined by rests as frequent as the nature of the business will admit. Other methods are in use, in which the relevant cost is arrived at avowedly by an estimate and no assumption is made that an actual historical cost is involved. One such method is that of "standard cost" by which a predetermined or budgeted cost per unit is taken: another obtains an estimated cost by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

There are two systems known respectively as the "base stock" method and the "last in, first out" (*Lifo*) method which we shall mention in some detail later. Neither has any considerable currency in this country.

### Determination of True Profit

So much for the circumstances of our problem. If the *Fifo* method is applied at a time of rising stock prices it is quite obvious what will happen. The sale proceeds are on a level that is higher than the level ruling at the time when the stock sold was acquired. The cost of the stock which is bought to maintain the stock volume and which is in this sense a "replacement" is reflected in the fig-

ure of cost that is appropriated to the closing inventory; and this cost, because it is carried forward, is not charged against the receipts of the current year. The significance of these factors to any particular trader depends upon the rapidity with which he normally turns over his total stock and the speed and curve of the price inflation. But the general consequence that is noticeable to every trader is that, while his accounting method shows one figure of profit arising from the operations of the year, the figure of the profit that he can withdraw from the business is necessarily a lower one, since, unless he is to face a reduction of his business by carrying a lower volume of stock, some part of the ostensible surplus must be retained to meet the higher prices of the new stock. He complains that to that extent his accounting method fails to show a true figure of profit and that it is unfair to require that his profits for the purpose of taxation should be ascertained by such a method.

If one stops to ask what is the true profit that is earned under conditions of rising stock prices, the answer would depend upon a choice between the two contrasting points of view that we have already noticed in discussing depreciation of fixed assets. On the one hand, economic analysis, concentrating attention on "real wealth", would say that the trader's income could only be computed after allowing for the cost of replacing the stock sold: for income is defined as the surplus that is available to be disposed of without impairing the maintenance of real wealth. Consequently a trader who sells 1,000 units of stock in the course of a year for a sum greater by £1,000 than he gave for them has not made a real profit if, owing to rising prices, he has had to invest the whole of the surplus in replacing the same number of similar units. At the end of the period he stands exactly where he started from. It is possible to accept the truth of this analysis without accepting that it affords the most equitable method of measuring profit under a system that seeks to do equal justice between many different kinds of income, both those derived from the employment of real capital and others. And it is easy to see how difficult it would be to translate the conception into a workable formula for the assessment of tax: for it assumes that there can be assigned to every business a figure of normal stock volume within the limits of which purchases constitute replacement, whereas in fact there is no rule that determines such normality and the actual volume of stock, and indeed the type of stock, vary from date to date, as also does the relation of cash or other liquid assets to the investment in stock.

On the other hand, if money is taken as the measure of profit, even in a time of fluctuating prices, there is no objection to the proposition that a trader has made a profit when at the close of the period of account it is found that he has received from the sale of his goods a sum larger in the aggregate than the sums he expended on acquiring or manufacturing them and on disposing of them. According to this view a profit has not the less been secured in that set of transactions because other goods, which have not yet come into account, have been acquired at a higher price. The profit or loss resulting from the new set of deal-

ings will be assessed or allowed for in a succeeding period according to the event. Given the inherent assumption of the *Fifo* method that the trader does in fact choose to sell his stock in a strict order of seniority, even at times when the cost of acquiring the older stock may be out of relation to the current cost of acquiring the new, we see no defect in the logic of this point of view.

It is unfortunate that part of a trader's profit, when obtained under these conditions, has come to be spoken of as an "inventory profit". The phrase is quite intelligible in a technical sense, but it is misleading if it is taken to mean that any part of the profit obtained lies in the increase of the value of the closing inventory over the value of the opening one. A profit arrived at by writing up an inventory to current values irrespective of cost would be illusory and misleading, in that it would be founded on an unrealized appreciation in value. But this is not the way in which the figures of the opening and closing inventories enter into the trading or manufacturing account. These figures are not estimates of value at all. As we see it, these accounts are not concerned with asset values: their function is to present a summary record of income on the one hand and consumption and expenditure on the other. The figure of opening stock is a figure of unabsorbed cost brought forward from the previous year to be placed against the receipts of the current year. Similarly, the figure of closing stock denotes those costs which, being unabsorbed in the current year, are carried forward to be charged against the receipts of the succeeding year. Neither denotes a stock value. The element of value enters into the account in one way only, that a fall in the market value of the stock, the costs of which are to be carried forward in the closing inventory, may sufficiently indicate that some part of those costs has become irrecoverable: if so, that amount of cost is written off instead of being carried forward either by a direct reduction of the figure of the carry forward or by setting up a provision to cover the fall in value. This seems to us the more accurate version of the rule that in a trading account the figure of the closing stock may be taken at "cost or market value, whichever is the lower".

It is plain to us that the recent years of fluctuating prices for commodities, particularly the period of the opening of the war in Korea, have directed much attention to this inflationary element in trading profits. With costs of stock replacement rising some part at any rate of the ostensible profit is automatically reinvested in new stock at higher prices. The high rate of taxation on business profits makes it seem peculiarly onerous to the trader not merely that he should be taxable on this element of his profit at all but also that he should be called upon to abstract from his liquid funds the cash required for immediate tax payment to the Revenue. Consequently we received numerous representations from various witnesses to the effect that the conception of taxable profit should be adjusted to admit of a provision out of profits to cover this element of stock inflation.

We have already indicated that, given the *Fifo* assumption, we should find great difficulty in upholding the logic of this claim or in working out

a satisfactory formula for applying it in such a way as to cover the element of inflation without covering at the same time a positive increase in the volume of stock. The principal difficulty is bound up with the fact that a trader who keeps his accounts on the *Fifo* basis shows by the form of the account that the desired appropriation would be a reserve made out of profits and not a provision to be charged against profits. So long as the *Fifo* basis is employed it looks as if the tax consequences must follow the same conception. This led us to ask, however, whether there is anything in the tax code or any governing principle of taxation that requires the adoption of *Fifo* by all traders, even at a time when its employment produces such unwelcome results.

**Fifo**

There is nothing in the tax code itself that prescribes any rules for ascertaining the basis of cost or for "valuing" stock in trade. The presumption is that such rules are to be extracted from trade practice and the principles of commercial accountancy. Nor do legal decisions in the Courts appear to have built up any body of doctrine even if it had been proper for them to supply rules upon a subject that seems eminently one of sound commercial practice. The most that legal authority can be said to have required in this connection is that, in estimating profits for tax assessment, the figure taken for the cost of articles sold must represent a real attempt to arrive at their cost and must not be fixed by reference to some arbitrary or fictitious standard, such as is involved in some forms, at any rate, of what is known as the "base stock" method. But even so this requirement has no bearing on the question whether there is any particular sanctity in the *Fifo* method if other methods, which seem better adapted to the circumstances of a business or the commercial conditions of the day, are or come to be recognized by the trading community and professional accountants.

The first Tucker Committee devoted some attention to problems of stock valuation in connection with inflation. They alluded to the fact that "there are no general provisions in the existing Income Tax Acts which lay down how trading stock is to be valued in computing profits for tax purposes"; stated that the formula which is generally accepted as a description of the proper way to value trading stock is "cost or market value, whichever is the lower"; and concluded that in present circumstances it would be undesirable to have specific statutory rules to cover the method of valuing stocks in all businesses within the United Kingdom tax net. This conclusion, again, is not directed to the problem of the basis upon which cost itself is to be ascertained. And it is that which seems to us to be the crucial question for the present purpose.

For the case put to us on the part of the Board is that, in effect, *Fifo* is the only permissible method for the purpose of tax assessment. No doubt such a claim would not be supposed to admit of no qualifications, since, for instance, it is obviously inapplicable to those businesses in which the items of stock are capable of specific identification. But, generally speaking, it is claimed that *Fifo* ought to be treated as if its adoption were a statutory obligation

of all taxpayers in the computation of their business profits. This seems to us a very large claim, having regard to the variety and complication of the business activities to which it would be applied. Nevertheless, it is supported by more than one consideration of importance. We shall notice them in due course, but it is convenient to deal with one by way of preliminary.

*Fifo,* it may be argued, is the method that is based on "historical cost" and is the accepted method according to the practice of accountants in the United Kingdom. Therefore the computation of profits for the purpose of tax should correspond with the accepted practice of commercial accountancy unless there is some overriding principle of the tax code that requires otherwise. But it seems to us that the problem now under review cannot be disposed of in this way. First, the premise itself is not quite accurate. *Fifo* is an accepted method and the one which hitherto has been the most widely used, but it is not the only accepted method. As we have said, "average cost" is used; so is "standard cost". Indeed there are two or three industries in which the "base stock" method has been used since far back in their history. Secondly, we see a real danger that in times of high taxation the mere circumstance that taxing authorities insist upon a particular method of computing profits tends to perpetuate that method in general use, both by accountants and by business concerns, for there are very great difficulties involved in changing over for other purposes to a system of computation that is not treated as valid for the purposes of taxation.

It is within our knowledge that in recent years many businesses in the U.S.A. and Canada have adopted the *Lifo* basis. This method, in effect, reverses the assumption on which *Fifo* proceeds. In the result, the costs allotted to the sales of any period reflect substantially the prices at which purchases were made during the same period. By consequence, the costs that are carried forward as the costs of the closing inventory reflect the costs of an earlier period, to the extent that the volume of the opening stock has been maintained throughout the year. No "inventory profit" arises: on the other hand, we should not regard the method as one that creates a "reserve" out of profits except on the assumption, which we do not make, that there is some inherent validity in the *Fifo* method.

In the years 1938 and 1939 the U.S. tax code was altered so as to give statutory recognition to the use of *Lifo,* though subject to a number of conditions as to the right to adopt it or to depart from it. It had been used by a number of companies for some years before that date. A recent decision of the Exchequer Court of Canada[1] has affirmed the propriety of its use in Canada for the purpose of computing taxable profits. The Income War Tax Act of Canada, as the United Kingdom code, offered no definition of "cost": and the case was decided on the principle that, failing any direction in the Act "what costs are properly chargeable against the gross income must depend upon accepted business and accounting principles".

We must notice two further considerations that are advanced in sup-

[1] *Anaconda American Brass Ltd.* v. *MNR,* [1952] 3 D.L.R. 580.

port of the proposition that the *Fifo* method should be the only one allowed to be employed in the computation of income tax profits. One is that for tax purposes there is a special importance in precise ascertainment of the income of the year in question, for rates change and it is not enough for justice between taxpayers that a system is used which is designed to secure a fair reflection of profits over a run of years. It is pointed out that, for other purposes, this principle may be of less importance, since consistency of treatment according to an intelligible system may be the main requirement. We agree with the point made, without thinking that it can be in many cases a determining consideration, but it does not seem to us that there is any good reason for saying that the *Fifo* method necessarily leads to a more precise ascertainment of income than other possible methods. The second is that it is desirable to have one prescribed method of stock valuation for all taxpayers who have assessable business profits, since the use of a single method for everyone is likely to produce the most even-handed justice. Considering the immense variety and complexity of business, of business processes, of their conditions and circumstances, we find it impossible to give any weight to this argument. It seems to us just as likely that the reverse would be true. We will take as instances two extreme cases. The dealer in perishable goods, say a greengrocer, carries stock: so does a gold-refiner or a fabricator of metals. In the one case it is important to know the dates at which the various items of stock were acquired, and the order of their disposal is a concern of the business. In the other the trader's concern is to ensure that he has in hand a volume of stock sufficient to meet his customer's requirements, but he is indifferent to the history of the separate items which have gone to make up his raw material and to the order in which he draws upon them. It is unlikely that his selling price will in fact be based on the cost of any single acquisition. With such differences to be covered we do not think that there is any valid presumption that a single rule for ascertaining the cost of all sales in all businesses will be the fairest one for taxpayers generally.

It would be an incomplete survey that ignored the general economic significance of *Fifo* in contrast with other methods of computing profits. Its effect is to impose a relatively higher tax charge at a time of rising prices and a relatively lower charge when prices fall: this is its main importance since, stock prices being likely to fall as well as rise over a period, it is not easy to make valid generalizations as to which of the possible methods is the most reliable revenue producer. Associated with rising prices at home, *Fifo* has attractions in its tendency to repress business activity: with falling prices its attraction is its opposite tendency. Associated with rising external prices, its economic value must be more debatable: for while it tends to intensify that shortage of liquid funds which was a recent phenomenon, its influence can be beneficial in relieving an exceptional strain on the country's balance of payments.

There is weight in this: but to give it determining weight is another matter. It will have more weight in its practical significance if effect is given to our later recommendation to move

corporate taxation on to a current year basis, for then the influence of taxation on business decisions is likely to be more direct. But, on the other hand, we must characterize as largely theoretical these generalizations about the relevance of taxation policy or accounting technique to the actual course of action of business men, and a good deal of allowance must be made for the fact that decisions often have to be taken long before their tax consequences can be ascertained. We doubt whether any of the considerations that we have set out will have much bearing one way or the other on what would anyway be the aim of an intelligent trader—to buy the minimum amount of stock when prices are at their peak and the maximum amount when they are at their lowest.

**No Single Method Recommended**

Our conclusion is that it would not be advantageous for the tax system to contain a requirement that all businesses must use a single prescribed method in valuing their stock in trade for the purpose of computing taxable profits. That makes it irrelevant to consider the further question whether, if there were to be a single method, *Fifo* would be the most suitable one. No doubt it has solid advantages from the general economic standpoint: but the gist of what we have been trying to stress is that businesses are so various in nature that what is the most suitable method to reflect the true annual profits of one cannot be expected to be the most suitable method for every other.

**Rules Proposed**

Certain questions remain to be cleared up if it is to be said explicitly that no single method is obligatory. It must not follow from this that any trader may use for tax purposes such method as he pleases, so long as a qualified accountant will pass his accounts. Nor must it follow that a trader is to be free to dodge about from one method to another in successive years, adapting his choice to the conditions so as to minimize his tax. That would be an obvious field for abuse.

The first difficulty is probably not so great as might appear. There is only a limited number of possible methods of valuing stock, so long as the primary condition is observed that figures allocated to stock, whether stock sold or stock retained, must represent a real, not an arbitrary, figure of cost. Questions of this sort are the constant concern of the professional bodies of accountants in this country and we have no doubt that they will be strict in their recognition of permitted methods. We do not think that a method should be accepted at all for tax purposes unless it —

(1) is designed to secure that the cost assigned to any item of stock in trade represents a real figure for the cost of that item and is not arrived at by an arbitrary or fictitious process; and

(2) is calculated, if used consistently over a period of years, to give a fair reflection of the profits of each year.

We do not accept the idea that it would be impossible to frame a set of rules that would adequately control a trader's freedom in the adoption of an accounting method or in the change from one accounting method to another, without requiring a universal adherence to *Fifo*.

We think that an adequate control is secured for this purpose if effect is given to the principle that, despite rising prices, there is no permanent exclusion from taxable income of an element to reflect the fall in the purchasing power of money. There is set out accordingly in Appendix 2 to this report [see below] the outline of a scheme which we have worked out on this basis and which we recommend for adoption. It will be seen that paragraphs 8, 9, 10 and 11 are designed to meet such contingencies as realizations of stock or changes in the nature of stock owing to alterations of the trader's business, or cessations of business owing to change of ownership; and, generally speaking, they secure that stock provisions no longer required because of those contingencies should be written back to taxable profit.

We are not unmindful that a scheme of this kind cannot be made to work without some cost in staff and in tax revenue. But when we tried to make some estimates of the amounts involved, we found that there were so many unknown factors that reliable calculations could not be offered. There are, however, certain general consequences to be expected from the implementation of our proposals that will give some measure of the weight of the change.

The trader will have to accept the cost of keeping such records as we regard as essential for a participation in the scheme. Tax Inspectors will have a more complicated system of control to maintain than they maintain at present and they will have to face an appreciably heavier burden of work in ensuring that the conditions of the scheme are properly observed by a trader who has adopted it. There is, of course, no means of knowing how widely it would be adopted.

On the other hand we cannot regard all this additional work as merely an extra burden due to our proposals. We think that the present system of control in relation to stock values is one of the weak points in tax assessment. By focusing attention on their basis and by laying down a set of definite rules to take the place of the uncertain principles that offer the only guidance today the scheme proposed will have the advantage of improving the whole method of control in this important matter.

The extent to which the yield of tax might be affected depends primarily upon the state of future economic conditions and the number and range of taxpayers who adopted the scheme. Given that stock values continue to remain relatively stable, as in the last two years, any reduction of yield would be limited to those trades in which values continued to increase and within them would depend on the proportion of base stock to total stocks. But a general rise in prices of the order of magnitude that was visible in, say, 1950-51 might mean a very heavy reduction indeed.

Against these reductions would have to be set the recovery of tax arising from such events as cessations of business or a reduction of stockholding below the figure of base stock.

We do not think that the effect of these considerations is to outweigh the advantages of instituting a scheme on the lines that we propose. What we are seeking to do is to put the treatment of stock in the computation of business profits on a more

rational basis than it rests upon at present: and until that is done estimates of "loss" of tax seem somewhat to beg the real question.

## APPENDIX 2

### Changes in the Trader's Method of Valuing Stock in Trade

1. The basic assumption is that the trader will count as profit or loss respectively the difference between the first cost and the ultimate sale proceeds of his stock in trade, that is to say, in spite of rising prices no permanent exclusion from income is permitted to reflect the fall in the purchasing power of money. Nevertheless, during the continuance of his business the trader should be permitted to value his stock in hand on a basis appropriate to the type of business carried on by him, provided that such basis, if used consistently over a period of years, fairly reflects his profits.

2. Accordingly, the trader would have an option to value his stock on any of the following bases, with liberty to value parts of the stock on one basis and other parts on other bases as he may opt: —

(1) Cost at the accounting date computed —
   (*a*) on actual cost of identifiable parcels, or
   (*b*) on the "first in first out" method, or
   (*c*) on the basis of the moving average, or
   (*d*) on the "standard" cost basis, i.e., on the basis of a budgeted cost per unit, or
   (*e*) on estimated cost obtained by pricing the stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal

   whichever is appropriate to the type of business and the nature of the stock concerned.

(2) Market value of the stock at the accounting date, that is, either the price at which the stock could be replaced by purchase or the realizable value of the stock on a going concern basis, namely, after deducting from current selling prices the estimated further expenditure to be incurred in bringing the stock into the state in which it would be sold and the costs of sale, including delivery.

(3) A combination of the lower of cost or market value for each item or group of items of stock at the accounting date.

(4) Where base or standard quantities of raw materials, work in progress or finished goods are proved to the satisfaction of the Board of Inland Revenue, with the right of appeal on the part of the taxpayer to the Board of Referees, to be essential to the proper functioning of a business, those quantities of the same or similar goods may be valued on the base stock principle adapted so that any net additions to the quantity of stock held are brought into the stock valuation at the average cost of the additions. The initial stock at the commencement or first adoption of the scheme would then be valued at actual cost at that date and all replacements of that stock up to but not exceeding the initial quantity would be

valued at the same prices. All additions to the respective quantities of stock, after deducting the consumption or disposals during the accounting period, would be valued at the average cost of those additions. The cost of the additions thus ascertained would be added to and averaged with the initial stock to form a moving average price of the entire stock of each of the respective kinds held by the trader. Any subsequent net reductions in quantity of stock would be regarded as having been used or disposed of out of the entire stock at the average cost price so ascertained thus avoiding the necessity of identifying any reduction with a particular addition or "layer" of stock as is required under the U.S.A. system.

If at any accounting date cost or market value computed as in (1) and (2) above respectively is lower than the value determined under (4) the lower value may be substituted and that lower value must then be adopted as the opening figure for the next accounting period.

3. As a matter of mechanics in the trader's accounts the stock could be brought in at the figure resulting from the adoption of the chosen basis; alternatively, and this is to be preferred both for accounting reasons and so as to enable the Revenue to have a ready control, the trader could enter his stock at actual cost in his balance sheet and create a stock provision to reduce that cost to the chosen basis of valuation; such provision could then be deducted as a disclosed item in the balance sheet from the stock or included as a provision on the liabilities side of the balance sheet.

4. The trader should have the right to adopt whichever of the above bases he chooses at the first accounting date after the new scheme comes into force, or at any subsequent accounting date, but having once adopted such basis he should not be permitted to change from it for tax purposes except with the consent of the Board of Inland Revenue and subject to such conditions as they may require, with a right of appeal to the Board of Referees against any refusal or any condition imposed by the Board of Inland Revenue.

5. Bases 2(1), (2) and (3) are conventional in this country. Basis 2(4) is a combination of the base stock and *Lifo* method of valuation and although not a new idea, being in fairly general use in the U.S.A. and Canada, it has not been generally used here.

6. There would appear to be no inherent transitional difficulties; the same basis of valuation must obviously be employed at both the beginning and end of the first accounting period for which the scheme has been adopted. The opening stock therefore will have to be valued on the new basis at the opening date. In the event of a change this will differ from the basis of valuation at the close of the preceding accounting period. It could be argued that the adjustment to the new basis at the beginning of the new basis could appropriately be ignored but on the other hand equity demands that such adjustment should be included as a credit (or a debit) in the tax computations, otherwise, taking the life of the business as a whole and bearing in mind that ultimately there should be brought to

credit the excess of proceeds over cost, the leaving out of this adjustment would constitute an unjustifiable gap in this conception. On balance, therefore, it seems that any uplift should be included as a taxable credit, and any reduction in value as an allowable loss at the date of the change.

7. There next falls to be considered the question of whether a trader, having adopted one of the permitted bases, should be allowed to switch to another of such bases and whether the difference caused by switching should be brought into account for tax purposes. It is suggested that this facility should be permitted provided always that the basis of valuation adopted is not lower than any one of the four bases detailed above. The effect of the switch would be included as a taxable profit or as an allowable loss.

8. Problems arise in determining what should be done in the event of any one of the following: —

(1) A change in the nature of the business so that the whole of its stock is realized and it holds no other stock.

(2) A change in the nature of the business so that henceforth the stock held is different in character from that formerly held.

(3) A change in the ownership of the business constituting a cessation for tax purposes.

9. In regard to 8(1), the stock in respect of which the provision will have been created, i.e., which has been effectively written down for tax purposes below historic cost, will no longer be held, therefore, in principle the provision or write-down is no longer required so that the whole of the proceeds of that stock should be brought to account for tax purposes.

10. In regard to 8(3), cessation, the basic principle is that when the business comes to an end the provisions or write-down of stock are no longer required and should be brought back into the tax computations. So as to protect the Exchequer against the possibility of these sums not being taxed in full owing to the operation of the cessation rules, it is suggested that the amount brought back should be separately assessed in much the same manner as a balancing charge on plant and machinery is dealt with on a cessation. Special cases, however, require separate consideration. These are: —

(1) Company reorganizations and amalgamations; in this field it is suggested that if there is no material change in the beneficial ownership of the share capital, i.e., there is a continuance of common control, the rules should be the same as for the sales of plant and machinery between companies under common control, namely, that the existing tax values may be transferred from the vendor to the purchaser.

(2) In the case of individuals the inclusion of the stock write-back in the income of the year of cessation of business might well throw the taxpayer into a much higher rate of surtax than would otherwise be the case and there seems a good reason for granting a right to spread back this special credit in so far as assessment to surtax is concerned. The number of years spread is a matter of choice but it is suggested that three would be appropriate.

11. With regard to 8(2), the general rule should be that a trader cannot be permitted to use, for the purpose of his stock-pricing, prices ruling at dates earlier than his first acquisition of the respective types of stock concerned. Consequently, where there is a change in the nature of the stock, stock of one kind being disposed of and replaced by stock of a different kind, any stock provisions previously set up and retained against stocks of a kind no longer held should be written back to profits; and as regards the new kinds of stock the trader should be in the position of adopting the scheme afresh with effect only from the date of purchase of the kinds of stock and on the bases of the costs then current.

There can, however, be a change in the kind of stock without there being any change in the nature of the business. An example in point is that of raw materials which, whilst different from, are nevertheless of the same nature as, are interchangeable with and have been substituted in use for, the raw materials held at the end of the previous accounting period. In such a case it might be reasonable, if practicable, to ignore the substitution and permit the goods in stock at the end of the accounting period to be valued on the basis of the prices or costs ruling for them at the date when the scheme commenced or the trader first adopted it or first acquired the substituted lines as the case may be.

**A LAYMAN'S GLOSSARY OF ACCOUNTING TERMS**

*Diminishing Balance.*

# Twenty Years of Canadian Wheat Board Operations

C. E. GORDON EARL

THE MARKETING of grain through a Government Board is not new in Canada. In June 1917 the Canadian Government adopted a policy of controlling the distribution and price of Canadian wheat in order to prevent, as far as possible, any wide fluctuations in wheat prices which might result from speculation or from the wartime hoarding of grain supplies. Accordingly, the Board of Grain Supervisors was established on June 11, 1917. This was a compulsory Board which acquired all wheat produced in Canada and which had full jurisdiction in the marketing of the Canadian wheat crop. Trading in futures on the Winnipeg Grain Exchange was suspended during the period of the Board's operations from September 1, 1917 to July 21, 1919. Just ten days after the cessation of government wheat operations under the Board of Grain Supervisors, the Canadian Government re-entered the field of wheat marketing. The futures market was again closed and The Canadian Wheat Board was created on July 1, 1919 to handle on a compulsory basis the 1919 wheat crop and the balance of the 1918 crop.

However, there was a marked distinction between the Board of Grain Supervisors of 1917 and The Canadian Wheat Board of 1919, in the kind of relationship which each of these Boards had with wheat producers. When the Board of Grain Supervisors acquired wheat, a fixed price was paid to the producers. Since the fixed price was also a final price, the operations of the Board were for government account. The Canadian Wheat Board of 1919 paid to producers not only a fixed initial price, but also issued to them a participation certificate which entitled them to a share in any surplus which might subsequently be realized from the Board's marketing operations. This carrying-on of Board operations for producer account was a new principle that was recognized later in marketing legislation.

After the cessation of operations by the second Board in the autumn of 1920, wheat prices showed a generally downward tendency. Whether rightly or wrongly, producers attributed to the Board system of marketing the better prices which had prevailed during the operations of the two government Boards from 1917 to 1920. When prices declined through the period 1920-23, producers agitated for a resumption of the Wheat Board operations. There was much

discussion in that period concerning the power of Parliament to control the grain trade in peacetime. However, Parliament yielded to the persistent pressures of western producers, and in 1922 enacted enabling legislation designed to clear the way for a wheat marketing board. At the same time concurrent legislation was passed by the Saskatchewan and Alberta Governments (while Manitoba did not follow suit). Saskatchewan and Alberta attempted to proceed with the organization of a wheat board, but their efforts failed, chiefly because of their inability to obtain competent men for it.

**Phase of Cooperative Marketing**

After failing to secure a compulsory wheat board, western producers next turned their attention to the possibility of cooperative marketing. The Alberta Cooperative Wheat Producers Limited began handling and merchandising wheat for its members in the fall of 1923, followed by the Saskatchewan and Manitoba Pool organizations and their central organization, the Canadian Cooperative Wheat Producers Limited, in 1924. Voluntary cooperative marketing was thus substituted for marketing through a compulsory governmental agency. These organizations, pooling producers' grain and acquiring their own country elevators and terminals on a large scale, played a major role in the marketing of wheat during the period 1923-30.

**Stabilization**

With the increased selling difficulties of 1928 and the sharp declines in grain prices which occurred late in 1929, the pools were confronted with larger problems. The trend back to government participation in wheat marketing began when the three provincial governments were called upon to extend financial guarantees to the pools. The Government of Canada reappeared in the wheat marketing picture in 1930 when the pools ran into further troubles resulting from falling prices and limited demand. This was marked by the institution of market stabilization measures which, in essence, amounted to government holding of cash grain and purchasing of futures at times when such action seemed necessary to stabilize the market. The government's market stabilization operations were carried on by the central selling agency of the pools, financed by the lending banks under guarantee by the Government of Canada. Under these operations a substantial volume of wheat was acquired, and in the latter phases, large sums of money were involved.

**The Canadian Wheat Board Act, 1935**

In the 1935 Session of Parliament attention was directed to the enactment of new legislation which would provide a means of disposing of the large wheat holdings that had been acquired under government stabilization and, at the same time, would create machinery suited to the dual purpose of handling new crops and affording to producers a measure of price protection. The Canadian Wheat Board Act of 1935 established the Wheat Board as a marketing organization to purchase wheat from producers on a voluntary basis, and to engage in the necessary marketing activities to dispose of wheat delivered to it. The Act of 1935 provided for governmental responsibility in the establishment of Board initial prices. It provided that any surpluses realiz-

ed by the Board in the sale of producers' wheat be payable to the producers on the basis of their deliveries to the Board, and that any deficits incurred by the Board were for the account of the Government of Canada.

**Early Wartime Period**

With the outbreak of war in 1939, the Canadian Wheat Board entered upon a period of new and enlarged activity. The highlight of the years to 1943 was a wheat surplus. The immediate impact of the war was to narrow export markets sharply for Canadian wheat, leaving the United Kingdom as the principal external wheat market available to Canada. At the same time, there was in Canada a record sustained production of wheat over a period of four consecutive crop years from 1939 to 1942. The Wheat Board was therefore called upon to perform the dual function of conserving in Canada vast quantities of wheat against a time of later need, while supplying a limited volume of wheat and flour to the United Kingdom and a few other markets.

Under these wartime conditions more government action in the storage and production of Canadian grain was essential. Beginning in 1940, the powers of the Wheat Board were enlarged to permit control of producers' grain deliveries at country points, and the government took measures to enlarge immediately available grain storage capacity in Canada. Also, in order to meet a strong wartime demand for livestock and meat products, policies were adopted to assist in the adjustment of western farm production to fill Canada's huge feed grain requirements. Despite these measures, however, the commercial carryover of wheat in Canada on July 31, 1943, was 595 million bushels, nearly six times the prewar commercial carryover of 102 million bushels of wheat existing on July 31, 1939.

**Special Wartime Operations for Government Account**

The Wheat Board, acting on behalf of the government, also conducted a number of special wartime operations which could properly be considered as subsidiary to the chief function of the Board of marketing producers' wheat. In order to encourage the production of oil seeds for war purposes, the Government of Canada directed the Board to control the marketing of flaxseed, sunflower seed, rapeseed and soybeans. In accordance with government policy the Board purchased and sold stocks of these commodities at substantially the same price, with marketing costs paid by the government. The Board was charged with the responsibility for the administration of the Canadian Government's price ceiling policy for grain in the Western Division, and for the maintenance of floor prices for oats and barley. The Board became responsible for the collection of equalization fees on exports of oats and barley (these fees representing the difference between controlled domestic prices for oats and barley and the higher prices obtainable for these grains in export markets). The Board also administered drawback payments to flour millers and processors of wheat for human consumption in Canada as a means of controlling the price of domestic flour.

**Later Wartime Period**

When the fortunes of war turned in favour of the Allies in 1943 the first impact of enlarged demand for

export wheat was felt. The highlight of the years 1943 to 1946 was the disappearance of the wheat surplus which had crowded Canadian storage facilities in the earlier war years. In these years all of Canada's huge wartime wheat reserves, together with a large part of our current wheat production, entered into consumption. The pressing objective of the Board operation was to effect a rapid movement of huge quantities of wheat into seaboard positions to meet existing demand.

The first large and unexpected demand arose in the United States in 1943-44, when over 150 million bushels of wheat and a large volume of oats and barley were shipped to that country for feeding purposes. In 1944-45 the opening of the Mediterranean area revealed a need for further large quantities of Canadian wheat. With the invasion of France came the rapid liberation of all Western Europe, and again large quantities of Canadian wheat were called for in 1945-46. By the middle of 1946 this country had made available to millions of people in Europe and Asia the last of her wartime wheat reserves together with a substantial part of her 1945 crop marketings. The magnitude of this wheat movement is indicated in the reduction of the commercial carryover of wheat from 595 million bushels on July 31, 1943 to about 70 million bushels on July 31, 1946.

**Sole Agency**

When export markets for Canadian wheat began to open in 1943, increased upward pressures were placed upon the ceiling that had been imposed on wheat prices in this country. A government announcement on September 27, 1943 brought about the discontinuance of trading in wheat futures on the Winnipeg Grain Exchange and the constitution of the Canadian Wheat Board as the sole agency to receive Western Canadian wheat from producers. At the same time Board holdings of wheat in 1940, 1941 and 1942 crop accounts, amounting to some 300 million bushels, were purchased by the government as Crown wheat. The Board disposed of the Crown wheat stocks government account for special purposes such as the fulfilment of Canadian commitments under mutual aid and the provision of subsidized wheat for domestic use. This purchase by the government permitted the 1940, 1941 and 1942 crop accounts to be closed out and a final payment thereon to be distributed to producers. The final payments marked the start of a series of profitable wheat operations on the part of the Canadian Wheat Board and on each succeeding pool the Board has since had a surplus for distribution to producers.

When the Wheat Board became the sole commercial marketing agency for western wheat in 1943, authority for this extension of Board powers rested in the War Measures Act until 1945, and subsequently in the National Emergency Transitional Powers Act until 1947. However, in July, 1946 this country entered into the Canada - United Kingdom Wheat Agreement. It was held at that time that the proper peacetime implementation of this international wheat agreement could best be effected if the Wheat Board continued to exercise its exclusive marketing powers.

Accordingly, to provide for the perpetuation in peacetime of Board powers beyond the expiry date of the

government's wartime emergency legislation, Parliament amended the Wheat Board legislation at the 1947 Session by writing the "sole agency" features into the Canadian Wheat Board Act itself. Commencing in 1949, Canada has continuously been a party to the first and the revised International Wheat Agreements. The peacetime marketing powers acquired by the Board under the 1947 amendments have been extended from time to time by Parliament, and the Board is currently authorized to act as the sole agency to receive commercial wheat in the Western Provinces until July 31, 1957.

At the 1949 Session of Parliament provision was made for the powers of the Board with respect to wheat to be extended to the commercial marketing of western oats and barley.

**Significance of Initial Prices**

Important powers devolve upon the Board in the matter of price protection and market stabilization for the producers. Under s. 25 of the Canadian Wheat Board Act the Board is directed to undertake the marketing of wheat (as well as oats and barley) produced in the Western Provinces in interprovincial and export trade. For this purpose the Act requires the Board (1) to purchase all western wheat, oats and barley offered by a producer for sale and delivery to the Board at an elevator or in a railway car, and (2) to pay to the producer an initial price per bushel according to grade. For each crop year an initial price is set by order in council for the basic grade of wheat, oats and barley, and initial prices for all other grades are then established by the Board with government approval in relation to the basic grade.

Here we have probably one of the most significant features of the Wheat Board system of grain marketing. The fixing of Board initial prices for wheat, oats and barley is a matter of far-reaching importance for the well-being of the 240,000 prairie producers of grain in commercial quantities, and for all of the other sectors of the Canadian economy that depend upon prairie agriculture for part of their market.

It is a natural development that the Government of Canada should have final responsibility in the establishing of initial prices since the government assumes very large financial obligations in connection with the Wheat Board's operations. Under the Act, all Board surpluses accumulated in the marketing of grain must be paid to the producers who delivered the grain to the Board, while any deficits incurred are for the account of the government. Consequently, because the degree of risk borne by the government is closely related to the level of the initial price, the government, together with the Board acting in an advisory capacity, gives intensive consideration to the establishment of initial prices from year to year.

In spite of the importance of this subject, however, there does not seem to be any one basic principle which governs the fixing of initial prices. For example, in the fixing of the Board initial wheat price in 1938 and 1939 consideration was undoubtedly given to the devastating effects of the price levels of the 1930's upon the western economy. The Government of Canada not only considered the market value of wheat, but also attempted to give some measure of support to the economy of Western Canada. In the marketing of the 1938

and 1939 crops, the Board incurred deficits of $61.5 million and $8.4 million respectively.

On the other hand, in the years from 1940 to the present time the fixing of initial prices by the government has no doubt been more closely related to market values and to a basis which would enable the Board to operate with a surplus and a final distribution to producers. Each successive pool account since 1940 the Board has in fact operated with a surplus, thus resulting in a distribution of funds to producers beyond the guaranteed price levels established by initial prices. This has eliminated for the past decade and a half any necessity of calling upon the national treasury to meet a Wheat Board deficit. Nevertheless, the potential larger effect of the Board's initial price is important for its does serve as a measure of basic protection to producers and constitutes a stabilizing element in the western economy.

Early in the Five-Year Pool (operated by the Board from August 1, 1945 to July 31, 1950) the practice was introduced of increasing the level of initial prices within the pool period. This development has been continued in the administration of various wheat, oats and barley pools since that time. Whenever the Governor in Council authorizes an increased initial price within a pool period, the Board's country buying price is raised by the amount of the increase for all grain purchased from producers after the effective date of the increase. At the same time a retroactive (adjustment) payment is made to producers on all grain delivered to the Board prior to the effective date of the increase.

Basically, the raising of initial prices within a pool period reflects a policy of conservative initial payments early in the crop year, which may later be increased as Board selling proceeds. By taking into account the financial position of the pool, an effort is made to assure the government that higher initial prices will not result in a Board deficit for the whole pooling period.

### Commercial Basis of Operations

While the *modus operandi* of the Board is outlined by parliamentary statute and by order in council, and while in some instances the powers and duties of the Board are subject to approval by the Governor in Council, these powers and duties are fundamentally similar to those given to any corporate body through the medium of its letters patent of incorporation and its supplementary by-laws. The Wheat Board has power to enter into any transactions relevant or incidental to the purchase, storage, transportation and sale of grain. It may engage in ordinary commercial banking operations on its own credit and may sue or be sued in its own name.

### Role of the Grain Trade

Despite the magnitude of its operations, however, the Wheat Board does not own or operate grain handling facilities of any kind. The Board works through the facilities possessed by private and cooperative elevator organizations, shipping and exporting companies and flour and feed mills, who act as Board ents in accordance with the provisions of signed agreements between themselves and the Board. Immediately upon delivery by a producer into an elevator or railway car, western-grown wheat,

oats and barley become subject to Board ownership and control. The companies acting as Board agents receive remuneration for their services either by means of commissions or through carrying charges.

When a producer delivers wheat to a country elevator he receives payment from the elevator company on behalf of the Board basis the fixed initial price in effect at the time of delivery. From the date of purchase the elevator company as a Board receives carrying charges for handling this wheat, consisting of storage, plus interest to reimburse the company for funds disbursed to the producer on behalf of the Board. It is the duty of the elevator company to ship wheat received from producers to terminal elevators at the Lakehead and Vancouver, and to interior terminal elevators and mills, in accordance with Board instructions. As these shipments are completed to the destinations indicated, the company receives warehouse receipts or mill outturns as documentary evidence of wheat unloaded. When these documents are presented to the Board the company is reimbursed by the Board on the basis of the initial price for the grade and quantity set forth in the document, and the point of unload.

Board sales of wheat are negotiated either through the medium of agents or directly by the Board on its own initiative. In order to effect sales for shipment from St. Lawrence or Atlantic ports, or for domestic consumption in Eastern Canada, it is necessary for the Board to transport its supplies of wheat to eastern destinations. It is the shipping and exporting companies, acting as agents of the Board, who undertake to move wheat into saleable and exportable positions in the East in accordance with Board direction. The Board's eastern wheat supplies are sold to the shipping and exporting companies as "agency stocks" on a provisional price basis, and the Board receives a provisional advance from the companies. When a sale has been completed by the agents to an ultimate buyer, the shipper or exporter involved submits an account sale to the Board setting out the final disposition of the Board's "agency stocks". At the same time all necessary adjustments are made for the provisional advance originally paid to the Board and for all forwarding charges incurred in the eastward movement.

**Magnitude of Board Operations**

A few figures on the actual operations of the Board in marketing western wheat, oats and barley will serve to indicate the strategic role played by the Board in the economy of the three Prairie Provinces and in the general economic structure of Canada. From August 1, 1935 to the end of the crop year 1953-54 the Board has taken delivery from producers of a total of 5,273 million bushels of wheat, having a value basis the fixed initial prices in effect at time of delivery of $6,238 million. Since the Board commenced the marketing of producers' oats and barley in 1949, a total of 524 million bushels of oats and 533 million bushels of barley with a value of $315 million and $490 million respectively, basis the fixed initial prices in effect at times of delivery, were marketed by producers through the Board to the end of the crop year 1953-54.

During most of the crop years since 1945-46 the Government of Canada has directed the Board to make in-

creases in the initial prices paid to producers of wheat, oats and barley. As a consequence the Board from time to time also made adjustment payments to producers with respect to wheat, oats and barley delivered by producers between the commencement of the crop year in question and the effective date of the increased initial payment for that crop year. Since 1945 Board adjustment payments to producers have amounted to $592 million for all grains to the end of the crop year 1953-54.

The marketing operations of the Board in respect to these large quantities of grain have resulted in deficits totalling some $82 million which were payable by the Government of Canada, and in surpluses amounting to $822 million which were repayable by the Board in the form of interim and final payments to producers. The deficits referred to here were incurred through marketing operations on the 1935, 1936, 1938 and 1939 crop accounts. It should be noted, however, that during these years the Board operated as a voluntary Board, and only received wheat from producers when the open market price for wheat fell below the fixed initial price offered by the Board. It is apparent, therefore, that under conditions such as these Board operations must necessarily result in deficits.

### Board Administration

At the present time four commissioners comprise the Wheat Board, whose appointment to office and rate of remuneration is fixed by the Governor in Council. The Board appoints its own executive officers necessary to the conducting of its operations, including in the main a secretary, a general sales manager, a comptroller, a country operations manager, a solicitor and the managers of several branch offices. The executive officers in turn have associated with them assistants and employ personnel necessary to ensure the proper conduct of Board business and implement its decisions.

The Board organization is not subject to the provisions of the Civil Service Act in the appointment of officers or the employment of staff.

The Board itself meets in regular sessions to discuss the policies and problems related to the marketing of western grain. Board discussions revolve around such matters as the transportation, handling, storage, financing, pricing and sale of grain, and the delivery of grain by producers.

### Cost of Administration

A major consideration in the administration of a public body is the personnel requirements and the costs of operation. Both of these factors will be affected to an important degree by the number of separate operations which the Board is conducting at any one time. During the first year of its operations in 1935, for example, the Board employed an average of 130 persons with an annual payroll of about one-quarter of a million dollars. As the scope of Board operations increased, the personnel employed increased correspondingly. Subsequent to 1944 a number of the operations conducted by the Board on behalf of the Government of Canada as war expedients were completed and the personnel employed by the Board decreased accordingly. Beginning on August 1, 1949, personnel requirements were again extended by the inclusion of western oats and barley

within the jurisdiction of the Board. By July 31, 1954 the Canadian Wheat Board was employing 730 persons in its various offices located at Winnipeg, Calgary, Vancouver, Washington, D.C. and London, England, and its annual payroll reached a total of slightly more than $1.8 million for the crop year 1953-54. The Board's total administrative and general expenses, including the payroll, were just under $2.8 million for the same year. This amount does not include items of expense applicable to actual marketing operations such as storage charges, interest and freight differentials.

It is necessary, of course, to allocate to the various operations conducted by the Board the proportionate share of the total administration expenses that is applicable to each individual operation. This allocation is accomplished principally on a cost analysis basis and on the basis of the bushels handled by each particular account. It is interesting to note that throughout the years of the Board operations since 1935, the per-bushel cost of administration expenses in the handling of producer grain has never exceeded two-fifths of one cent per bushel.

In conclusion it should be said that an organization carrying out operations on the magnitude that has been described here can be successful in the long run only on the basis of a competent and well-trained personnel which devotes itself to the day to day tasks of the organization and to the larger purposes of the organization. In the administration of the affairs of the Canadian Wheat Board, great stress is laid upon the personnel factor.

# Spotlight on Prospectuses

*(Part IV)*

C. W. LEACH

In the United Kingdom the methods followed in the distribution of securities differ somewhat from our own. There, the *entrepreneur* in the matter is known as the "issuing house" very often in the form of an institution known as a "merchant bank". The merchant banks originated as privately owned concerns but now have considerable public participation. They do a variety of financial and banking transactions apart from what would be recognized as "commercial banking". These include trading in foreign exchange, dealing in bullion, dealing in bills of exchange, arbitrage in securities and foreign exchange, "deals" in companies, and finally the business of arranging new issues. The merchant bank as such is unknown in this country but most of their functions are performed in the United States and Canada by some of the investment dealers.

The Issuing Houses Association consists of some 55 members and there are evidently a number of other concerns who act as issuing houses while not being members of that Association. By way of comparison there were 18 "principal issuing houses" in Canada at the corresponding date.

**Procedure for Issuing Shares**

The issuing house, then, is the one who will either seek out companies requiring capital or conversely be approached by them. It will design the issue to meet the needs of the company and match the mood of the market and generally arrange for the preparation of the prospectus. Following this point, however, the procedure differs from the Canadian. Instead of buying the issue *"en bloc"*, as is done in Canada, the general practice is for the issuing house to "underwrite" the issue for a stated commission. In other words, subscriptions are invited from the public (returnable in some cases to the company, in some cases to a bank and in others to the issuing house) and any shares not so taken up must be bought from the company by the underwriter.

In these circumstances, it is common practice for the issuing house to invite other issuing houses and large investors, such as insurance companies, investment trusts and pension funds to become sub-underwriters

for a smaller commission, perhaps two-thirds. Thus if "the underwriters have to take up the issue themselves" it does not mean financial embarrassment for dealers as it might in this country, but only that a group of insurance companies or similar institutions have made an investment that they were quite willing to make all along.

In this way the success of the issue is assured and the risk is spread. Variations of this procedure take place. The issuing house may place the issue more or less entirely with other houses or large investors, so that an invitation to public subscription may not be made, or if made may be a mere formality. Thus the issue is "privately placed". It may also offer the shares by letter to its own clients, there being rules which limit public circularization.

One incidental effect of all this is that the issuing houses as underwriters or sub-underwriters may have continuing investments in the securities they have underwritten and thus may exert a more lasting influence in a company's affairs than is normally the case in this country.

**Role of the Stockbroker**

Another participant in the arrangement is a stock broker. All issues of any importance, including bonds (or debentures as they are likely to be called) are listed or "quoted" on one of the stock exchanges, of which the London Stock Exchange is, of course, the most important. The application for quotation must be sponsored by a member of the exchange, who will later help make the market in the issue, and his sponsorship is important to the success of the issue. It is also usual for the Council of the Exchange to require that at least two jobbers (members who trade for their own account) agree to open a book in the shares. One direct result is that a good market may be quickly available and the general public may be able to buy an attractive security (at an appropriate price) on the open market, but in fact out of the portfolios of the underwriters, or conversely the underwriters may be able to dispose of a less successful issue over a period of time.

To complicate matters somewhat, it sometimes happens that a stockbroker will act as underwriter even though that is not his normal function. This is done apparently only in cases where the success of the issue can be foreseen by sub-underwriting or otherwise, because the broker does not usually have the resources to take up a large investment.

The foregoing resume is sufficient to show that the procedure is different in a number of respects from that to which we are accustomed, and the functions of the issuing house can be summarized in three categories:

1. As the professional adviser who for a fee from a company undertakes all the work of an issue, including the preparation of the prospectus, the arrangements for underwriting, the preparation of announcements and advertising, and in general the coordination of the services of solicitors, accountants and brokers.
2. As an *entrepreneur* where it acquires the whole of the issue and offers it to the public; in such a case it may and usually does arrange an underwriting of a substantial portion of the issue.

3. As the agent in a "placing", that is to say where a portion of the company's capital is sold privately, generally to institutional investors. This is often accompanied by arrangements for a stock exchange quotation whereby the issuing house will make available to the market some reasonable proportion of the shares.

**Provisions of the U.K. Companies Act**

The Companies Act was completely rewritten in 1948 following an extensive enquiry by a Royal Commission headed by Lord Justice Cohen. Sections 38 to 40 of the Act describe the circumstances under which a prospectus must be issued and the general procedures to be followed, and while somewhat more comprehensive than the requirements of the Dominion Companies Act, are still similar, and for that reason need not be repeated here. The Fourth Schedule to the U.K. Act contains the counterpart of our so-called statutory information and the requirements for the report of the auditors.

Reports from the auditors are required in connection with the following four matters:

(a) profits or losses
(b) assets and liabilities
(c) rates of dividends paid
(d) accounting date.

The report on profits and losses must be in respect of each of the five financial years immediately preceding the date of the prospectus and must include the profits and losses of subsidiary companies, either separately or as a group or combined with those of the holding company with allowance for minority interests.

It is also required that the report shall indicate by note any adjustments to the profits and losses which should be made or which have been made. It appears that, in earnings reports, auditors in the United Kingdom are much more inclined to make adjustments to the profits of companies as already reported in their annual accounts than is the case in this country. It may perhaps be assumed that these cases arise largely where companies are becoming public companies for the first time or being first brought into a group of public companies, for the principle is also enunciated in professional writings that in general the audited accounts should be altered as little as possible.

**English Institute Recommendation**

The English Institute, like the American and our own, issues a series of recommendations on accounting principles and its Recommendation XVI says that the circumstances where adjustments are required are usually (a) where facts have subsequently become known which would have affected the accounts if known at the time of their preparation (the best example of which is the rebate of profits under contracts subject to cost audit), (b) where there are material sources of revenue or categories of expenditure which are not expected to recur, for example where subsidiary companies or divisions of a business may have been acquired or disposed of, and (c) where there has been a change in accounting principles applied or where accepted accounting principles have not been applied. A good example of the last would be the revision of inventory valuations to a consistent basis.

As would be expected the tenour of the Institute's recommendations is to the effect that while the account-

ants' report is necessarily confined to past results and does not purport to deal with future prospects, the investor is entitled to regard the report as a source of information upon which he may rely in forming his own assessment of the prospects of the business. Therefore the reporting accountants should exercise their own judgment as to whether or not any particular adjustment would be appropriate. With this understanding, however, it may be of interest to record the Institute's attitude on a few important points.

1. Taxation

In the U.K. the treatment of taxation in earnings reports is much more difficult because of the differences in the tax system. Profits taxes are affected by the amount of dividends paid and income taxes are considered to be payments on account of the ultimate liability of the individual shareholders and are in effect recovered from them on the payment of dividends. Since the amount of dividends may vary as between the period covered by the earnings report and future periods after the securities have been issued, it follows that the taxes paid in the past may be no indication whatever of the pattern to be expected in the future. As a result it is recommended that in the absence of exceptional circumstances the report need not make any provision for taxes.

2. Stock in Trade

Emphasis is placed on the need for a review of the method of valuing stock in trade, to see that proper inventory methods have been consistent from year to year, reference being made to the construction business where methods of drawing down profits from contracts vary considerably.

3. Non-Recurring Expenditures

Adjustments to eliminate non-recurring expenditures are discouraged because of the difficulty of establishing that any particular expenditure is in fact foreign to the pattern of the business but it is suggested that where a loan of fixed amount is to be repaid out of the proceeds of an issue it may be appropriate to eliminate the interest thereon with due disclosure.

4. Changes in Sources of Income

It may or may not be desirable to allow for material changes in the nature of the business or the sources of income depending upon the circumstances. Where another business has been acquired by means of an issue of share or loan capital it may be appropriate to show the income earned by that business during the whole period of the earnings report. (Where a business is to be acquired out of the proceeds of a new issue a report on the profits of that business must be given in accordance with the requirements of the fourth schedule to the Companies Act.) On the other hand where another business has been acquired out of existing resources, the profits of such business for the years prior to the acquisition should not be included since it merely represents a change in the use of the resources. The same considerations would apply in reverse if a distinct and material section of the business had been discontinued or sold and the profits attributable thereto were ascertainable.

5. Capital Expenditure Written Off

It is recommended that these should not necessarily be adusted, regardless of whether or not they have been allowed for taxation purposes, the theory being presumably that the company has committed itself to an accounting policy and should not be encouraged to tell a different story when it appears to be to its advantage. In cases where such an adjustment is made the effect on the adequacy of the depreciation provisions should be considered.

6. Period Covered by the Report

The accountants should always consider whether the minimum period required by law or by stock exchange requirements presents an adequate view of the results and if it does not they should extend the period or make appropriate comments.

The Institute also considered in an earlier recommendation (Recommendation XIII) the question of depreciation in relation to prospectuses. In addition to dealing with a number of points with which most accountants are familiar, this recommendation follows a strong line for cases where fixed assets have been written up. It says that while it is not practical to make adjustments in the depreciation provisions for past years the report should indicate the approximate future annual requirement computed on the basis of the valuation and give a comparison with the actual provision made in the last year.

The introductory comments to the recommendation state that "depreciation will in future necessarily be calculated on the valuation figures, resulting in future earnings being charged with sums which might be considerably in excess of those charged in the accounts during the period covered by the report". If this statement is to be taken at its face value, it means that having once written up the figures, and perhaps having sold securities or obtained credit on the strength of them, the company must then write off the new values out of future earnings and that members of the Institute would not be expected to tolerate the practice of charging the annual depreciation on the increase against an appraisal reserve.

Indeed, the Institute's recommendation goes so far as to say that even in those cases where the appraised value of fixed assets is not introduced into the books but is merely used as a representation as to the asset cover in the text of the prospectus, the reporting accountants should ascertain that the directors' estimate of the future profits available for dividends as shown in the prospectus has been arrived at after appropriate deductions have been made for the net profits which it will be necessary to retain as reserve in order to maintain the asset cover indicated in the prospectus. If such deductions have not been made, the accountants should see that there is sufficient information in the prospectus to show how far the directors have taken this factor into account. It is stated that they should satisfy themselves on these points before consenting to the inclusion of their report in the prospectus.

The report on assets and liabilities required under the fourth schedule to the Companies Act must deal with the assets and liabilities of the company at the last date to which the ac-

counts were made up and if the company has any subsidiaries, must in addition deal with the assets and liabilities of the subsidiaries either combined or separately with due allowance for what would be termed minority interests.

A balance sheet is not required and presumably would not provide compliance. It may be recalled that in an earlier recommendation the Institute recognized that a balance sheet contains elements which are neither asset nor liability and consequently that the use of the headings "assets" and "liabilities" is inappropriate and unnecessary. Consistent with this earlier recommendation, Recommendation XVI provides that the statement of assets and liabilities required for prospectuses be so arranged that the liabilities are deducted from the assets to arrive at proprietary interest. A typical statement (omitting the details of the main captions) would take the following form:

| | | |
|---|---|---|
| Fixed assets, less accumulated depreciation | | 1,000,000 |
| Current assents | 700,000 | |
| *Less*: Current liabilities | 200,000 | |
| Net current assets | ——— | 500,000 |
| | | ,500,000 |
| Provision for income tax | | 100,000 |
| Net assets excluding goodwill | | £ 1,400,000 |
| Representing – Preferred shares | | 600,000 |
| Ordinary shares | | 600,000 |
| | | 1,200,000 |
| Capital reserve | | 50,000 |
| Revenue reserves and unappropriated profit | | 150,000 |
| | | £ 1,400,000 |

The report on the rates of dividends paid must be in respect of each class of shares in the company for the five financial years preceding and needs no particular comment except to note that it is a requirement not found in this country. Similarly, if no accounts have been made up within the period three months before the issue of the prospectus, the accountants' report must contain a statement of that fact.

The London Stock Exchange has certain specific requirements which if not covered in the accountants' report or in the prospectus may call for a letter to be written to the Stock Exchange by the reporting accountants. The most important of these is that the accountants are required to confirm in writing that stock in trade has been properly taken and valued for the period covered by the report. Another is that the report on earnings is required for a period of ten years (or for whatever less period the company has been in existence).

*(To be concluded)*

# Professional Developments

**Excerpts from an address given by Sir Hartley Shawcross, M.P. in the Guildhall to the Chartered Accountants Students' Society**

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LAST OCTOBER Sir Hartley Shawcross, Q.C., M.P., Attorney-General in the last Labour Government and currently chairman of the General Council of the Bar, addressed over a thousand members of the Chartered Accountants Students' Society of London in the Guildhall.

As some of Sir Hartley Shawcross' remarks refer to subjects which are discussed from time to time in our columns, we are pleased to reproduce extracts from his address which was published in full in the December 10th issue of *The Accountant.*

*On Passing Examinations*: "Merely passing an examination is not the only thing. In our professions education is really a continuing process. It is not limited, as examinations sometimes have to be limited, to merely technical matters. You are not likely to get the most enjoyment out of life or to be the most useful member of your profession if you content yourselves with securing the necesssary qualifications and passing the necessary examinations.

"I believe it is very important to study rather more widely than you need to just for the purpose of passing your examination, to read a good deal more widely than the textbooks prescribe for you and to try to develop a broad background with other interests outside those immediately concerned with your own profession."

*On Reading Widely*: "Then, of course, in your profession, which has such an important and increasing part to play in the commercial and industrial life of the country and in the country's general economic affairs, it is very desirable, not only to read widely in the humanities, but also to make some study of economic matters; to read, for instance, those publications which the banks put out, the monthly magazines which almost invariably contain at least one very instructive article by someone who is a real authority. By doing that kind of thing, you will be able to play a much more useful and important part, both in your professional career and in the life and affairs – politics and economics – of your country as a whole.

"Do not confine yourself more than you are bound to do to the narrow technicalities in those years when you are training yourself for the career which you are going to follow. Your practice in the end in some established kind of employment will require you, as a qualified chartered account-

ant, to engage in clear thinking, to make courageous decisions on questions of policy and you will be much better able to make such decisions and to maintain a high standard of professional efficiency and conduct in your affairs if you have read as broadly and widely as you could."

*On Professional Honesty*: "Your task is primarily to serve honesty in commerce and business. These are, of course, dangerous and difficult days and not only highly competitive days. These are days in which we are all of us very much concerned with getting and spending as quickly as we reasonably can, and days in which very high rates of taxation make it very difficult for many to do so in an honest way. There are many opportunities to conduct malpraxis of one kind or another and depart from the strict standards of professional and commercial honesty. There are people who are prepared to juggle with the law and with figures if they can get the professional man to assist them. You must not allow yourselves to be parties to anything of that kind."

*On the Loyalties of the Profession*: "We carry 'the loyalties of the profession' from generation to generation. They are not things you can absorb from lectures and books. They are traditions and standards of conduct which you acquire by seeing how things are done during the very useful period of serving your articles before you start out on your own careers. They are things you find through constant association with the older members of your Institute and through consultation, when problems arise, with your more experienced colleagues.

"That is a thing which it is very important to remember, and it is another of the things which distinguishes your position as members of the profession from that of the ordinary individual engaged in trade or commerce. You are not someone who stands alone, you are a member of a profession. If you do anything wrong then, of course, you are letting the whole side down, you are lowering the tone of your profession. If you do anything right, on the other hand, you are promoting the interests of your profession, and if you find it necessary to take a stand on some point of principle which is right, although it may be unpopular, you will find the other members of the profession rallying round and supporting you. In a sense, a profession is a kind of brotherhood, and highly competitive as we are – yours is a competitive profession and so is mine – yet it is remarkable how we try and succeed in behaving towards each other in a really brotherly way. That is something which is vitally important to professional life.

"We have in our profession a threefold loyalty – a loyalty to our clients to do the best we possibly can for them, to use our skill and judgment as far as we possibly can in their interests; then we have a loyalty to the great and honourable profession to which we belong, to maintain its great traditions and high standards and, finally, above all, we have got a loyalty to our country and, I suppose, also to ourselves. If we succeed in maintaining these three loyalties, then, whilst we may hope to attain success, we can at least feel sure that we shall do nothing to injure the great profession to which it is our good fortune to belong."

BY GERTRUDE MULCAHY B.A., C.A

# Accounting Research

*The C.I.C.A. Research Department*

## Shareholders' Equity

The equity of the owners in any business is composed of capital contributed by the owners together with increases or decreases arising in the course of business.

In corporations, the elements of the shareholders' equity are classified under two main headings: capital stock and surplus. Capital stock is that portion of the shareholders' contributions allocated to capital. It does not necessarily represent the full amount contributed, but is that portion which the company is expected to maintain intact for the protection of the creditors. This restriction is not absolute. The right to redeem issued capital shares, if accompanied by proper legal action, provides for reduction of the amount specifically earmarked for the creditors' protection. In addition, continued losses on operations may reduce the net worth of a company below the amount designated as capital stock. The gradual depletion of the assets through unprofitable activities breaks down the safeguard originally provided for the creditors.

The term "surplus" is used in accounting "to designate the excess of the net assets over the total paid-in par value or stated value of the shares of a corporation" (C.I.C.A. Bulletin No. 11). This portion of the shareholders' equity is not merely an arithmetical balance. It is derived from specific sources. The items in this classification are either received by way of contributions or earned in the conduct of the business. The former includes amounts paid in by the shareholders as well as capital contributions from other sources. The latter is made up of the net accumulation of undivided profits less losses arising from the company's operations, and it includes the net gains on disposition of capital assets and on settlement of funded debts or other liabilities.

Although it cannot be classified under either of the two headings mentioned above, a credit arising from appraisal of assets, if recorded, constitutes part of the shareholders' equity. A restatement of assets on the basis of an appraisal does not bring about an increase in the liabilities of the company. Rather, it involves a restatement of the shareholders' interest in the assets. Their equity must therefore be adjusted to reflect a corresponding increase. Since this amount represents an unrealized appreciation, it cannot properly be described as a surplus.

### Form of Presentation

The shareholders' equity section has been presented in a variety of forms in published balance sheets. In the majority of cases, the component parts were grouped under a descriptive caption with a single total extended. Sub-classification headings and sub-totals within this section

were frequently used to distinguish the various elements of the owners' interests. Such a presentation not only clearly identifies the amount of the shareholders' equity in the company but also the items which make up this figure.

Variations of this form of presentation were also used but did not achieve the same degree of clarity. In some cases, the shareholders' equity section was properly designated with an appropriate heading, but the total of the items within the section was not extended. Under this procedure, a reader must add at least two figures together in order to arrive at the total amount of the shareholders' equity. In other instances, the designating caption was omitted, but the total of the capital stock and surplus items was extended in a single figure. A reader, unfamiliar with accounting principles, might be confused as to just exactly what this total represents.

In 1954 a substantial number of published financial statements did not show either a title for or total of the shareholders' equity. Capital stock and surplus items were shown independently without any indication that they represent the owners' equity in the company. The reader is left to his own resources to determine what items should be taken into consideration in determining the amount of the shareholders' equity.

The following examples have been selected from the published annual reports analyzed for the year ending in 1954. They have been included to emphasize the clarity of expression which can be achieved by proper classification of the components of the shareholders' equity. They are poles apart in the degree of effectiveness.

**Example 1**
**SHAREHOLDERS' EQUITY**

| | | | *1954* | *1953* |
|---|---|---|---|---|
| CAPITAL STOCK: | | | | |
| AUTHORIZED — | | | | |
| 1,050,000 convertible non-redeemable Class "A" shares without nominal or par value, entitled to fixed cumulative dividends of 50c per share per annum — | | | | |
| 5,500,000 Class "B" shares without nominal or par value — | | | | |
| ISSUED AND OUTSTANDING — | Class "A" shares | Class "B" shares | | |
| At September 30 1953 ..... | 144,518 | 5,141,020 | | $ 28,031,658 |
| Exchanged during the year | ( 21,476) | 21,476 | | |
| At September 30 1954 ..... | 123,042 | 5,162,496 | $ 28,031,658 | |
| RESERVES | | | | |
| For general contingencies ..... | | | 750,000 | 750,000 |
| For possible decline in inventory values ..... | | | 1,000,000 | 1,000,000 |
| EARNINGS RETAINED FOR USE IN THE BUSINESS — per statement attached ..... | | | 74,448,924 | 63,945,838 |
| | | | $104,230,582 | $ 93,727,496 |

## Example 2

| | | | *1954* | *1953* |
|---|---|---|---|---|
| **CAPITAL** | | | | |
| 6% Cumulative Preference Shares, par value $4.86 2/3 each | | | | |
| Authorized: 1,650,000 Shares | | $ 8,030,000 | | |
| Issued: 1,650,000 Shares | | | $ 8,030,000 | $ 8,030,000 |
| Redeemable Sinking Fund Preference Shares, par value $25 each | | | | |
| Authorized: 600,000 Shares | | 15,000,000 | | |
| Issued: 400,000 Shares* | $10,000,000 | | | |
| *Less*: Redeemed 112,445 Shares* | 2,811,125 | | | |
| Outstanding 287,555 Shares* | | | 7,188,875 | 7,612,500 |
| (*4% *Cumulative Series*) | | | | |
| Common Shares, par value $5 each | | | | |
| Authorized: 10,800,000 Shares | | 54,000,000 | | |
| Issued: 9,670,532 Shares | | | 48,352,660 | 48,352,660 |
| **SURPLUS AND GENERAL RESERVE** | | | | |
| General Reserve | | | 5,000,000 | 5,000,000 |
| Capital Surplus — *arising from redemption of Redeemable Sinking Fund Preference Shares* | | | 2,811,125 | 2,387,500 |
| Earned Surplus | | | 9,396,602 | 8,237,529 |

### Terminology re Caption

Table 21 of "Financial Reporting in Canada", set out below, shows the great variety of titles used by Canadian companies in describing the shareholders' equity section of the balance sheet. Although the most common title continued to be "Capital stock and surplus", terminology which more clearly identifies this section as representing the owners' interest has become increasingly popular. The use of caption "shareholders' equity [or ownership, investment, interest]" increased from 12.4% in 1953 to 17.1% in 1954. Such a trend obviously results from the efforts which Canadian companies have made in recent years to simplify the expression of financial information. The possibility of misunderstanding on the part of readers who do not realize that capital stock and surplus are in effect the components of the shareholders' interest is eliminated by the use of more descriptive headings.

The majority of the terms classified as "miscellaneous" made use of the words "capital" and "surplus". They included titles such as "Share capital and surplus", "Capital stock and retained earnings", "Capital and unappropriated earnings", "Equity" and "Net worth".

In 1954, 31.4% of the companies did not use a title for this section of the balance sheet. This is more than the number using any one of the many designations.

### Balance Sheet Disclosure of Source

In accounting for the shareholders' equity in a corporation, the emphasis is on the sources from which the proprietory equity has been derived. To

TABLE 21 — CAPTION FOR SHAREHOLDERS' EQUITY

| | 1953 | | 1954 | |
|---|---|---|---|---|
| | No. Co.'s | % | No. Co.'s | % |
| Capital stock and surplus | 57 | 20.7 | 59 | 21.4 |
| Capital and surplus | 50 | 18.2 | 47 | 17.1 |
| Shareholders' ownership / investment / interest / equity | 34 | 12.4 | 47 | 17.1 |
| Capital | 4 | 1.5 | 7 | 2.6 |
| Capital stock, reserves and surplus | 4 | 1.5 | 4 | 1.5 |
| Shareholders | 8 | 2.9 | 4 | 1.5 |
| Capital stock and earned surplus | 5 | 1.8 | 2 | 0.7 |
| Capital stock | 2 | 0.7 | — | — |
| Miscellaneous | 18 | 6.5 | 18 | 6.5 |
| Total shareholders' equity caption | 182 | 66.2 | 188 | 68.4 |
| No caption | 93 | 33.8 | 87 | 31.6 |
| Total | 275 | 100 | 275 | 100 |

understand the true nature of this section of a balance sheet, the reader must be able to readily determine how much of the net worth was produced by way of contributions, how much consists of retained earnings and how much, if any, was produced in other ways.

The importance of the disclosure of such information was stressed by the committee on terminology of the American Institute of Accountants in its recommendations relating to the balance sheet presentation of shareholders' equity. These proposals, originally made by the committee in 1949, were reaffirmed in "Accounting Terminology Bulletin No. 1, Review and Résumé" released in 1953. The recommendation that the term "surplus" should be replaced in statement presentation by terminology indicating the source of the various items has gained considerable acceptance. The eighth edition of "Accounting Trends and Techniques" shows that the number of survey companies who had replaced the term "earned surplus" with other words which more clearly indicated the source of this item had increased from 10% in 1947 to 54% in 1953. Although the term "capital surplus" is still being used extensively, 31% of the 1953 statements referring to capital or unclassified surplus disclosed information as to the sources thereof.

The Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants included in Bulletin No. 1 recommendations as to the minimum standards of disclosure in the presentation of the components of the shareholders' equity. Table 22 of "Financial Reporting in Canada" shows that, for the most part, the suggestions relating to capital stock have become generally accepted practices of statement presentation. Unfortunately, there does not appear to be the same degree of uniformity and clarity in the procedures adopted to disclose the corporate surplus. Recognizing the need for clearly defined direction in this area, the committee, in August 1955, made recommendations relating specifically to the classification

and presentation of the elements of surplus.

As in the American pronouncement, Bulletin No. 11 emphasized that "An adequate view of a company's affairs requires information as to the source of any surplus shown on the balance sheet." The committee believed that clarity of expression could be accompanied by proper classification and descriptions of the items of surplus. It was suggested that "A basic distinction exists between amounts received by way of contributions and amounts earned in the conduct of the business, (these being the only sources of realized surplus), and this difference should be recognized by classification on the balance sheet." The items of surplus should, therefore, be set out under two main headings, "earned surplus" and "contributed surplus". Statutory requirements of presentation and the disclosure of information concerning the segregation or availability of items of surplus should not distort the basic classification as to source. Such particulars should be set out in appropriate descriptions and/or sub-classifications under the two main headings or by way of explanatory notes on the financial statements.

Since the use of the term "surplus" has become firmly established in company law and finance, the committee did not suggest, as did the American committee, that all uses of the word should be discontinued in financial statements. The committee pointed out that "Experience shows, however, that a single-word designation of surplus on a financial statement is not sufficiently informative. Lack of uniformity in practice has led to the use of a variety of terms and this has created inconsistencies and ambiguity in many financial statements. The interests of clarity will be served if the word surplus is qualified, in every case in which it is used, with wording related to the method of classification of the various elements of surplus, and to the statutory requirements, if any, as to designations or descriptions." At the same time, it was recommended that use of the term "capital surplus" should be avoided because of uncertainties as to its meaning.

In discussing appraisal increase credits, the committee stated that this item, if recorded, should be set out as a separate item in the shareholders' equity section of the balance sheet. Because it does not represent an amount which has been realized, the appraisal increase should not be described as "surplus".

As mentioned previously, published financial statements have displayed a high degree of uniformity in practices used to disclose the details of capital stock. It is to be hoped that the suggestions included in Bulletin No. 11 will be helpful in clarifying and simplifying the presentation of surplus. Since the year end of the majority of Canadian companies is December 31, the impact of the proposals presented in August 1955 is not yet apparent.

(*Next month consideration will be given to the terminology used to describe the items of earned and miscellaneous surplus.*)

BY KENNETH M. PLACE, C.A.

# *Administrative Accounting*

## Communications As An Accounting Tool

Much has been written on the problems of communication in industry today. Not so much, however, has been said on a phase of the overall problem which is of equal importance, i.e. the usefulness of information. Because the end result of most industrial accounting is the presentation of information, in one form or another, to various levels of management, the whole field of communication and usefulness of information is of particular interest to the industrial accountant.

It is generally accepted in industry that information, if it is to be of value, must be timely. It also, of course, must be useful information, for there is nothing more exasperating to top management than for already overloaded executives to be presented with great masses of material which can only be classified as "BUMFPH". Accuracy, although naturally highly desirable, is not necessarily as important as timeliness since speed in reaching essential decisions combined with accuracy within reasonable limits will very often far outweigh in value the additional time required to achieve absolute accuracy, if such is indeed possible.

If it is accepted that speed in producing useful information is a prime requisite in industry, then our concern with communications is not as strange as it might at first seem. All accountants, whether they realize it or not, are concerned with the field of communications as a user of messengers, mail service, telephones, teletypes, etc. Unfortunately, however, too many tend to accept existing communications services without question as to their validity as a "tool of the trade".

When one begins to think of the bookkeeping aspects of accounting in terms of its basic functions the importance of good communication becomes apparent. The transfer of original entries to subsidiary ledgers, the later transfer of subsidiary ledger summaries to control accounts, the transmission of invoices to customers and of information to management and shareholders involves communication techniques ranging from the most rudimentary in the case of the small business with one accountant to a highly complex specialist service in large industry. It is surely obvious that the organization of information in such a way that it reaches those people who need to use it as quickly as possible and goes through the fewest possible processing steps is of prime importance to an efficient accounting service. The best available central accounting system can fail miserably if information originating in branches, factories, etc. does not flow smoothly into the cen-

tral organization. With the growing complexity of modern business, accountants must adopt a more active role in seeking out better methods of communication.

There are many communication tools available today with which accountants should be thoroughly familiar:

1. Mail service
2. Messenger service
3. Telephone and telegraph
4. Private wire telephone
5. Private wire teletype
6. Data transmission equipment
7. Facsimile.

Some comments on the possibilities inherent in the newer developments in communication techniques may be helpful.

### Private Wire Teletype

Private wire teletype has been with us for many years as a message transmission medium and uses a page printer in the usual installation. Higher speeds are obtained by substituting punched paper tape feed for direct typing. Both teletype printers and equipment such as the "Flexowriter" can type original documents and at the same time prepare a paper tape for later transmission over a teletype circuit. The receiving instrument can be either a teletype directly printing continuous forms or a tape perforater which produces a tape for later decoding by either a teletype printer or a "Flexowriter". These systems are quite well known to persons interested in "integrated data processing" and can be considered to be tried and proven.

### Data Transmission Equipment

Equipment is available which will permit the direct transmission of punched cards over either a teletype circuit or a telephone line. The telephone line can be either a private tie-line or an ordinary long distance circuit obtained by the simple process of placing a long distance telephone call. With the proper equipment at each terminal, punched cards can be fed into the sending unit and reproduced accurately at the receiving unit. When a teletype class of circuit is used transmission speeds are relatively slow, while on a circuit of telephone grade speeds are higher and automatic error detection is possible by automatically comparing a signal "echoed" from the receiving unit back to the transmitter with the original card.

Equipment of this type has interesting possibilities for users who make extensive use of punched card accounting equipment. Data transmission equipment of this type is already in use by one large American company.

### Facsimile

Facsimile means the direct transmission of photographs, diagrams and printed matter over wire circuits or by radio. It is by no means new since it has been in use by the press and press service for many years. Facsimile has, however, been subject to poor quality when low grade circuits were used and has, in the past at least, operated at relatively slow speeds.

New equipment has been developed recently, however, which may make facsimile more attractive for business use. At the moment the most likely application is for engineering firms or industrial concerns desiring to transmit sketches, plans, blueprints, etc. from office to factory

and vice versa. Where such an application exists consideration should also be given to using this equipment for form or data transmission. Where this is possible the added use might make this equipment economically attractive.

**Private Wire Telephone Circuits**

In contrast to teletype circuits which are usually leased on an eight hour day basis, private wire telephone circuits (tie-lines) are leased on an exclusive basis and are paid for on 24 hour usage irrespective of whether or not they are used for that period. A telephone tie-line is a much higher grade of communication circuit than a teletype line and, with the proper equipment, can handle a much greater traffic load. With these facts in mind it is felt that when a telephone tie-line is available, its use for data transmission at night and other slack periods should receive serious consideration. Optimum circuit loading and the use of existing facilities for other purposes might make improved communication facilities economically feasible in cases where a tie-line cannot be justified on the basis of message traffic alone.

We have in these brief paragraphs barely scratched the surface of a subject which should be uppermost in the mind of every accountant. Certainly the communications problem will have to be solved before a company can take full advantage of an electronic computer or other modern data processing equipment. But a communications problem is implicit in every accounting system both large and small, and with good communications substantial improvements can be made.

**The Usefulness of Information**

Some time ago, while reviewing the file on an internal audit performed at a plant, I noticed that in addition to a normal series of sub-accounts covering such items of cost as labour, materials, etc., this particular plant used a further group of sub-accounts, approximately 100 in number, to record one of the most detailed analyses of costs that I have ever seen. Upon questioning the necessity of these records, I was told that they had been developed over a number of years to answer specific queries that had been received. On review it was found that the vast majority of the queries had been of a non-recurring nature, and that great masses of information had been prepared, in some cases for as long as 25 years, which had never been used. Perhaps your first reaction is to say "Ridiculous — it couldn't happen here". On second thought, however, maybe you will wonder, "Can it happen here?". I suggest that it can.

One of the major time consumers in industry today is the production of unnecessary information. The example given here is simply one instance of the many many cases of wasted time and effort going into the production of such information. There are many reasons why this should happen, but perhaps the commonest is the very human desire to know as much as possible about the organization's operations without stopping to consider whether the particular information requested is going to be of any value. Then, once a request has been made, there is a very strong tendency to set up a system to provide the information on a continuing basis. There are many cases, of course, where it is not feas-

ible to determine whether the information is useful or not until it is actually produced. However, once it is apparent that the information is of no use, or of insufficient importance to justify the cost of obtaining it, action should be taken to ensure that its preparation is not perpetuated through failure to advise those responsible that it is no longer required.

Information is defined in the Oxford Dictionary in part as "informing, telling, things told, knowledge, item of knowledge". Since the provision of information to management for use in administering the enterprise's affairs is a vital function of industrial accounting, it is essential that the information be timely, accurate and useful. Fulfilling the first two requirements is largely a mechanical problem. The third requirement, however, necessitates the exercise of a considerable degree of judgment.

Let us take another look at the usefulness of the information to be supplied to management. First, there are a number of levels of management starting with the first level of supervision in the organization, and ending with the senior executive body, usually the board of directors. Naturally the quantity and detail required for all these various levels is different. Secondly, a large percentage of these members of management are not too familiar with all the ramifications of accounting. Nothing would be simpler than to flood management at all these levels with great masses of figures, but how much of this would be useful? In most cases, only a relatively small percentage. Accordingly, one of the accountant's most important functions is to consider just what data is required at these various levels to permit them to function effectively. Once the type of information to be supplied has been established, however, the accountant cannot be satisfied to simply sit back and grind it out. He must also interpret it intelligently for management to make maximum use of it. Certainly nothing can be more misleading than a mass of figures without complete explanations of their significance.

Only the surface of this particular topic has been scratched but the two most important factors to consider have at least been outlined, i.e. the appropriateness of the information supplied and the necessity of careful accurate interpretation of it. Even this brief discussion, however, would be incomplete without reference to one other extremely important fact. All information being supplied to management must be continually reviewed, amended, supplemented or otherwise revised to meet the ever-changing needs of industrial management today.

BY MELVILLE PIERCE, B.A., LL.B.

# *The Tax Review*

## Deductibility of Business Expenses

Unlike the Income Tax Acts of some countries, notably that of the United States, the Canadian Act does not contain a positive enactment setting forth the deductions which may be made in computing the income from a business for a taxation year. Section 2 of our Act states who shall be subject to tax, section 3 states that the tax shall be levied on their income, including their income from businesses, and section 4 says that income from a business is the profit therefrom. So far not a word about the deductions which may or shall be made in computing income from a business (or, for the matter of that, of the amounts which shall be included in that computation). Section 5 is concerned with the computation of income from offices and employments, and then sections 6 to 9 set out certain but by no means all of the amounts which are to be included in computing a taxpayer's income for a taxation year. Section 10 lists certain (but again not all) amounts which are *not* to be included in that computation, but it is not until we reach section 11 that we find anything said regarding the deductions which may be made in computing income from a business, and section 11 deals only with a relatively few matters, e.g., capital cost allowances, depletion allowances, interest on borrowed money, etc., reserves for doubtful debts, bad debts, scientific research, etc. Nowhere in the Act is there a provision which in express language permits the deduction of salaries and wages, rent for business premises, cost of goods sold, and other such basic matters, although these are certainly the most usual expenses for the great majority of businesses. (Nor for that matter is there any provision in the Act which says in express words that the proceeds of sale of merchandise or services are to be included in the computation of business income.)

Section 11, which is the only provision in the statute dealing expressly with deductions allowed in computing income, is followed by a provision (section 12) which sets forth in general language certain deductions which are *not* to be allowed in computing income. The first two paragraphs of this section have been repeated a thousand times in the tax cases, but their importance is such that they should be known by heart by every tax practitioner. The deductions which they prohibit are:

(a) an outlay or expenses except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer;

(b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Act.

It is manifest from the structure of the Act as set out above that section

12, including the above two paragraphs, is concerned with the prohibition of deductions and not with the allowance of deductions. Thus, while both of these paragraphs contain exceptions to the prohibitions enumerated, it is important to recognize that the exceptions merely narrow the scope of the prohibitions. To illustrate: the Dominion Lord's Day Act prohibits the doing of certain things on the Lord's Day except in so far as those things are permitted by the law of any particular Province. If the law of one Province permits the doing of things on the Lord's Day which would otherwise be prohibited by the Dominion Act it would not be true to say that the doing of those things on the Lord's Day in that particular Province was permitted by the Lord's Day but only that they were not prohibited by the Dominion Act. The case is the same with section 12 of the Income Tax Act. Certain outlays and expenditures are prohibited from deduction with certain exceptions, but here again it is not the exceptions from the statutory prohibition which permits the deduction of the subjects excepted, and if they are deductible at all it is because some other provision of the statute permits them to be deducted.

It may seem to some readers that the point is being belaboured, but the fact is that this is a subject which has given rise to long, perhaps tedious, and as yet inconclusive, debate in this country and at an earlier date in Great Britain whence our statute had its inspiration. It may also be asked what difference it makes whether business deductions are allowed under one particular provision of the Act rather than another. What is really important, it may be said, is to know what deductions are allowed and what are the rules and principles which govern their allowance. That is unquestionably true, but it will be found that the answer to the latter question is inextricably bound up with that to the former. It must not be forgotten when dealing with income tax that we are dealing with a statute and that at bottom every income tax problem is a matter of interpretation of the Income Tax Act.

If, then, as we have argued above, the Act contains no positive enactment setting forth the deduction which may be made in computing business income, and the exceptions contained in section 12 do not fill that void, where does one find the necessary authority? The answer is in section 4 which reads:

> Subject to the other provisions of this part, income for a taxation year from a business or property is the profit therefrom for the year.

The key words are "*profit therefrom for the year*", for the word "*profit*" by necessary implication postulates a computation in which incomings are brought in and outgoings charged against them. As Lord Cave said in *British Insulated and Helsby Cables Ltd.* v. *Atherton* (1926), A.C. 205, with reference to the similar scheme of the British Income Tax Act:

> It has been pointed out on several occasions that the British Act does not contain any express allowance or enumeration of deductions; and that effect can only be given to the provisions prohibiting any deductions not expressly allowed by holding that when a deduction is proper to be made in order to ascertain the balance of profits and gains for any year, it ought to be made notwithstanding those provisions, provided that it is not prohibited by the terms of the Act and the Rules. From this it fol-

> lows that in determining whether a particular item may or may not be deducted from profits, it is necessary first to inquire whether the deduction is expressly prohibited by the Act, and then, if it is not so prohibited, to consider whether it is of such a nature that it is proper to be charged against incomings in a computation of the balance of profits and gains for the year.

And in *Daley* v. *MNR* [1950], Tax Rev. 202 the President of the Exchequer Court of Canada (Thorson P.) held that the deductibility of a business expense was governed not by the prohibitory enactment in the statute but by the imposition of a tax on annual profit, and he further held that in applying that test the question to decide was whether the deduction in question was permissible by the ordinary principles of commercial trading or accepted business and accounting practice.

Much the same idea was previously expressed by the Supreme Court of Canada in the leading case of *Dominion Natural Gas Co.* v. *MNR* (1940) CTC 155, where the Court said that expenses to be deductible must be "working expenses", i.e., expenses incurred in the process of earning the income, and that this question was to be determined upon the principles of ordinary commercial trading.

The importance of locating the exact statutory authority for deductions in the concept of business profit as established by commercial and accounting usage rather than in the exceptions to the prohibitions of section 12(1)(a) and (b) really cannot be exaggerated. The reason is this. If deductions flow from the concept of periodic business profit then *prima facie* a taxpayer is entitled to charge off for tax purposes as well as for his own purposes all those expenses which are recognized as proper charges against revenue by commercial custom, the prohibitions of section 12(1)(a) and (b) only being applicable after that test has been passed. That being so the Court before whom the question is brought will consider the matter within the framework of commercial and accounting usage. If, however, it were otherwise, and the primary authority for deductions were contained in the exceptions to section 12(1)(a) and (b), the emphasis would be reversed: *prima facie* the taxpayer would be disentitled to any asserted deductions except those which he could bring within the express words of the exceptions, and the framework of reference would be the words of the prohibition instead of commercial usage. It cannot be doubted that the adoption of the latter approach would lead to the rejection of many deductions which would be permitted if the first approach were adopted.

It is necessary to say that Canadian judicial opinion has not yet crystallized in favour of either of the above constructions, and that the Chairman and two at least of the other members of the Income Tax Appeal Board undoubtedly favour the second approach. As has been intimated above, however, the views of the President of the Exchequer Court and some at least of the Judges of the Supreme Court of Canada are inclined toward the first-mentioned approach. If this writer may be allowed a prophecy, in due time judicial opinion in Canada will, for the same reasons as induced judicial opinion in Great Britain, resolve itself in favour of the first construction.

### Established Principles of Deductibility

The decisions of the Supreme Court of Canada and of the Privy Council have laid down the following general guides for determining the deductibility of expenses in computing business income under the Canadian Income Tax Act.

**1. Current Expenses**

The current expenses of a business are deductible. Current expenses for this purpose are those which recur from year to year or those which are of a recurring character as distinguished from expenses of a "once-for-all-time" nature. Sometimes, as in *Dom. Natural Gas Co.* v. *MNR, supra*, the phrase "working expenses" or the phrase "expenses incurred in the income-earning process" is substituted for the phrase "current expenses", but the meaning is the same. The deductibility of "current expenses", "working expenses", "expenses incurred in the process of earning the income" permits the deduction of such basic expenses as salaries and wages, rent for business premises, fire insurance of business premises, cost of goods sold, legal expenses, and most others.

As a matter of interest, the deduction allowed for the cost of fire insurance on business premises (and the proration of the cost over the duration of the insurance) demonstrates convincingly that it is not the purpose for which an expense is incurred that is the most significant factor in determining its deductibility but whether or not it is an expense of a recurring or once-for-all nature. Certainly fire insurance on business premises, is an expense directly referable to a capital asset but no one has yet questioned the right to the deduction for that reason. In the same way the expenses incurred by a business for legal services, if they are of the kind that recur in most businesses, e.g. in collecting bad accounts, will be held deductible, whilst the legal costs of acquiring or preserving a capital asset will be prohibited. Under the head "current expenses" fall such items as annual realty taxes, business assessment, postage, freight, etc.

**2. Non-Recurring Expenses of a Non-Capital Nature**

Current expenses are deductible, capital expenses are not. Somewhere between those two termini comes a class of expense which is neither the one nor the other, *viz* a non-current expense, i.e. a once-for-all-time-expense which is not incurred with a view to acquiring or preserving an asset or advantage of enduring benefit. An illustration taken from a well-known case is a payment made to rid a business of a burden, e.g. an undesirable employee who has a long-term contract.

Under this head are included unusual expenses which arise in the day-to-day carrying on of the business which are neither likely to recur nor possess any capital quality. For example, the Kellogg Co., manufacturers of breakfast cereals, were obliged to defend their right to use the name shredded wheat as descriptive of a product in an action for infringement of trademark brought by the Shredded Wheat Co. It was held that the latter company had no exclusive right to the name shredded wheat and the Kellogg Co. was successful. The Kellogg Co.'s legal expenses were neither of a recurring nature nor did they result in the ac-

quisition or preservation of any right of a capital nature. Nevertheless the expense was held to be deductible as having arisen by reason of the way in which the company carried on its day-to-day activities. On the other hand the legal expenses incurred by a gas distributing company in defending its principal asset, *viz* a long-term franchise for the distribution of gas in Hamilton, were held non-deductible, the expense being not merely non-current but made with a view to the preservation of an asset or advantage of enduring benefit to the company, namely its exclusive rights under the franchise.

### 3. Capital Expenditures

An expense of the above description, more specifically, one made once-for-all and with a view to the acquisition or preservation of an asset or advantage of enduring benefit to the business of the taxpayer, is expressly barred from deduction by the statute and would be barred from deduction in the year in which it is incurred by commercial and accounting usage, under which it would be deductible pro-rata over the period of its utility. Under this head fall expenses incurred to defend the exclusive right of a business to carry on business, an expense incurred for the acquisition or renovation (as distinct from repair) of a building. Until this year the cost of obtaining capital was also barred, but an amendment made at the last session of Parliament now permits the deduction of some at least of the expenses incidental to the floating of a bond issue or in issuing new stock. The deduction allowed for interest on borrowed capital has also been widened somewhat in recent years.

In conclusion, it may be said that while the principles of deductibility are not yet crystallized, the scope, or at least the intended scope of deductibility, is gradually being widened by Parliament through specific enactments.

BY J. E. SMYTH, C.A.

# Students Department

*Associate Professor, Queen's University*

### Notes and Comments

Canadian students of commercial law who still have to struggle over the somewhat mysterious contents of the Statute of Frauds will look with envy on their English cousins when they learn that a major part of that Act has now been repealed by the British Parliament; henceforth, in England, of the contracts previously affected by the Statute of Frauds only contracts of guarantee will require a note or memorandum in writing, signed by the party to be charged, to be enforceable.[1] Thus a statute which was passed in 1677, a few years after Charles I was beheaded, has itself finally "got the axe".

Possibly this change in English law foreshadows a similar amendment in the various provincial Statutes of Frauds in this country. The Statute of Frauds has been for long criticized[2] on the grounds that it is obsolete of its purpose, and may actually promote more fraud than it prevents: it is possible for a person aware of the statute to break certain of his oral promises with impunity, knowing that they should have been in some form of writing, signed by him, to be enforceable against him. Further, the statute only deals with certain types of contract, and a very odd assortment of contracts at that.

When the Statute of Frauds was first enacted, it served a purpose because the principals, in a legal action were not permitted by the rules then prevailing, to give evidence on their own behalf: hence the advantage, for the purpose of achieving a fair decision, of having the evidence in the form of a memorandum in writing signed by the parties. Since the principals in a civil action may now testify on their own behalf, the statute lacks its original justification.

* * * *

At the same time that the British Parliament repealed part of the Statute of Frauds, it also repealed the familiar section in the English Sale of Goods Act requiring evidence in writing of a contract of sale of the value of £10 and upwards. This provision was originally a part of the Statute of Frauds, but was later transferred to the Sale of Goods Act. It did, however, recognize certain acts of the parties as evidence of a contract of sale in lieu of a memorandum in writing (*viz.*, acceptance and receipt of the goods by the buyer; something given by way of earnest; and part payment). As yet no action has been taken by any of the provincial legislatures in Canada to repeal the counterpart of this section in a provincial Sale of Goods Act.

[1] See *The Harvard Law Review*, December 1954, pp 383-4. A signed writing is still also required for contracts in respect of an interest in lands, which are dealt with separately under the English Law of Property Act. The repeal of most of the English Statute of Frauds was made retroactive to June 4, 1954.

[2] See the Sixth Interim Report (1937) of The Law Revision Committee, cited in *Anson's Law of Contract* (19th edition), p. 66.

## THE QUESTION CORNER

Why are revenue account increases recorded as credits? (*Submitted by a student-in-accounts in Yorkton, Saskatchewan.*)

### Editor's Reply

While this question may seem elementary to those who are prepared simply to accept a bookkeeping rule of thumb, it is not so easy to explain *why* the rule is as it is. To answer the question, we must be able to bring the proposition within one of the established rules for debits and credits, and there are several possible answers.

Perhaps the first explanation that will occur to us is that increases in revenue amount to increases in proprietorship. Since in general we record increases in proprietorship by a credit, then we record increases in this particular kind of proprietorship by a credit. One difficulty with this interpretation is that proprietorship does not in fact increase by the amount of revenue (or gross income, as it is sometimes called), but merely by the amount of profit. (Profit is the excess of revenues over expenses.) At the same time as revenue is being recorded as an increase in proprietorship, there are also decreases in proprietorship taking place, in the form of expenses.

A second possible explanation for the rule is that the credit to Revenue account is a mere bookkeeping expedient because it is not usually possible on the occasion of each sale to credit separate accounts for each of the costs which have expired in connection with the sale, and to credit Profit and loss for the profit on that sale. Instead, the total amount of sales is accumulated in a "revenue" account until the end of the accounting period, when the various costs which have expired over the period can be determined and matched against the total revenue to determine profit or loss for the period.

Still another approach is to ask what revenue, in fact, is. We suggest the following definition: Revenue is the measure of the inflow of assets (in the form of money or accounts receivable) received by a business from its customers in return for goods sold and services rendered. If we accept this definition, we can say that revenue is really a source of assets; so that when we debit the asset account (Bank or Accounts receivable), we also credit Revenue account to provide a record (or explanation) of the source of the particular asset which has just come into the business as a result of the sales transaction. In this way we can distinguish between the assets which are attributable to sales revenue and those which are provided by other sources, such as proprietors and creditors. This is, of course, essential accounting information. By this reasoning, we credit Revenue account as a means of classifying a particular type of inflow of assets. The related outflows of assets to customers, as sales take place, have to be recorded independently as expenses.

(*Opinions expressed here are those of the editor himself, and comments and criticisms of his answer are invited.*)

## PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views of the various contributors. They are designed not as models for submission to the examiner, but rather to provide such discussion and explanation of the problems as will make their study beneficial. The editor will welcome discussion of the solutions published.

### Problem 1

*Primary Examination, October 1954 (Ontario)*

**Accounting I, Question 1 (15 marks)**

Newton and Raine have operated a partnership business for 9 years and now have decided to dissolve their partnership. Mr. Newton wishes to retire and Mr. Raine has been offered a position with a competitor, Greenfields Limited. On June 30, 1954 when the partnership business stopped operating, the balance sheet was as follows:

ASSETS

| | | | |
|---|---|---|---|
| Current: | | | |
| Cash in bank | | $ 4,000 | |
| Accounts receivable | $14,000 | | |
| Less allowance for doubtful accounts | 2,000 | 12,000 | |
| Merchandise inventory | | 21,000 | $37,000 |
| Fixed: | | | |
| Machinery and equipment | 6,000 | | |
| Less accumulated depreciation | 2,500 | 3,500 | |
| Automobile | 2,600 | | |
| Less accumulated depreciation | 600 | 2,000 | 5,500 |
| Goodwill | | | 15,000 |
| | | | $57,500 |

LIABILITIES

| | | |
|---|---|---|
| Current: | | |
| Accounts payable | | $16,000 |
| Capital: | | |
| F. Newton | $23,000 | |
| P. Raine | 18,500 | 41,500 |
| | | $57,500 |

1. Greenfields Limited agrees to buy the inventory and machinery equipment for $22,000 payable as follows:

| | |
|---|---|
| Cash | $ 2,000 |
| 6% bonds, due June 30, 1955-1959 | 10,000 |
| 10,000, $1 par value common shares | 10,000 |

2. All of the accounts receivable are collected during July except for one bad account amounting to $850 which cannot be collected.
3. The accounts payable are all paid by July 31.
4. The partners have agreed that upon distribution of the remaining assets, the automobile is to be transferred to Mr. Raine at book value, the Greenfields Limited bonds are to be transferred to Mr. Newton, and the common shares to Mr. Raine.
5. Profits and losses are shared 2/3 to Mr. Newton and 1/3 to Mr. Raine.

**Required:**

Journal entries to record the winding up of the partnership.

## A SOLUTION

### Books of Newton and Raine

| | | Dr. | Cr. |
|---|---|---|---|
| 1954 | | | |
| Jul. 1 | Realization account | 53,500 | |
| | Allowance for doubtful accounts | 2,000 | |
| | Accumulated depreciation on machinery and equipment | 2,500 | |
| | Accumulated depreciation on automobile | 600 | |
| | Accounts receivable | | 14,000 |
| | Merchandise inventory | | 21,000 |
| | Machinery and equipment | | 6,000 |
| | Automobile | | 2,600 |
| | Goodwill | | 15,000 |
| | To close assets to be realized into Realization account | | |
| Jul. 1 | Greenfields Limited | 22,000 | |
| | Realization account | | 22,000 |
| | To record sale of inventory and machinery and equipment | | |
| Jul. 1 | Bank | 2,000 | |
| | Bonds in Greenfields Limited | 10,000 | |
| | Shares in Greenfields Limited | 10,000 | |
| | Greenfields Limited | | 22,000 |
| | Receipt of consideration from Greenfields Limited | | |
| Jul. 31 | Bank | 13,150 | |
| | Realization account | | 13,150 |
| | Collected on accounts receivable | | |
| Jul. 31 | Accounts payable | 16,000 | |
| | Bank | | 16,000 |
| | Payments of accounts owing at June 30, 1954 | | |
| Jul. 31 | Capital — P .Raine | 2,000 | |
| | Realization account | | 2,000 |
| | Transfer of automobile to P. Raine at agreed value | | |

| | | | |
|---|---|---|---|
| Jul. 31 | Capital — F. Newton | 10,900 | |
| | Capital — P. Raine | 5,450 | |
| | Realization account | | 16,350 |
| | To charge partners with loss on realization, and close Realization account | | |

| | | | |
|---|---|---|---|
| Jul. 31 | Capital — F. Newton | 12,100 | |
| | Bonds in Greenfields Limited | | 10,000 |
| | Bank | | 2,100 |
| | To record final distribution to F. Newton | | |

| | | | |
|---|---|---|---|
| Jul. 31 | Capital — P. Raine | 11,050 | |
| | Shares in Greenfields Limited | | 10,000 |
| | Bank | | 1,050 |
| | To record final distribution to P. Raine | | |

## PROBLEM 2

*Intermediate Examination, October 1954*

**Accounting II, Question 1 (10 marks)**

What is meant by each of the following:

(2 marks) (a) depletion,
(2 marks) (b) sinking fund bond,
(2 marks) (c) control account, and
(4 marks) (d) 7% convertible cumulative participating redeemable preferred shares?

### A SOLUTION

(a) Physical utilization of wasting assets or absorption of investment in natural resources through amortization of their cost by charges to operations over the period during which the quantities or units of such resources are extracted or exhausted.

(b) A certificate of indebtedness under seal issued under an agreement which requires the issuer to set aside periodically a sum which, with interest, will be sufficient to pay off the bonds on maturity.

(c) An account containing the totals of a series of transactions recorded individually in detail accounts in a subsidiary ledger.

(d) 7% — a fixed rate of annual dividend.
*Convertible* — a right to convert preferred shares, usually into common shares at the option of the holder.
*Cumulative* — Undeclared dividends accumulate as a claim upon past and future earnings and generally, in the event of liquidation, upon the assets before any distribution can be made to common stockholders.
*Participating* — In addition to the fixed rate of preferred dividends, the shares participate under specified conditions with the common stock in the distribution of profits.
*Redeemable* — subject to redemption by the corporation.
*Preferred* — a class of stock which has a claim prior to common stockholders upon the earnings of a corporation and often also upon the assets of a corporation in liquidation.
*Shares* — equal parts into which every class of stock of a corporation is divided.

*Examiner's Comments*

A common error was to describe a "sinking fund bond" as a bond purchased with money from a sinking fund, that is, an investment.

## PROBLEM 3

*Intermediate Examination, October 1954*

**Auditing II, Question 1 (10 marks)**

On scrutinizing the cash receipts record of a small manufacturing company, CA noted an amount of $525 recorded as sundry income. CA was told that this had been received from B, a relative of the plant manager, in payment for an old punch press.

The only entry in the machinery account during the year was a debit of $6,500 recording the purchase price of a new punch press.

**Required:**

(6 marks) (a) List the audit procedures CA should follow in investigating this sundry income entry and in determining the necessary adjustments in the company's records relative thereto.

(4 marks) (b) Describe the adjustments required in the company's records in connection with the disposal of the old punch press.

## A SOLUTION

**(a) Audit procedures**

1. Check correspondence and sales invoice covering the sale of the punch press.
2. See that the approval of a senior officer of the company has been obtained for the sale to the relative of the plant manager, and for the price charged.
3. Ascertain the original cost of the punch press and the depreciation accumulated on it to the date of sale.
4. Check the company's computation of the annual depreciation charge for the punch press.
5. Check the accounting treatment used in recording the cost of removing the old press and installing the new one.

**(b) Adjustments required on the books**

1. Adjust the current year's charge for depreciation to take account of the disposal of the old punch press during the year.
2. Debit or credit accumulated depreciation account with the amount necessary to adjust depreciation expense for the year.
3. Charge accumulated depreciation account with the correct depreciation accumulated on the punch press sold.
4. Credit the appropriate fixed asset account with the original cost of the punch press sold.
5. Debit sundry income account with $525 to eliminate from this account the sale price of the punch press.
6. Credit or debit profit and loss on disposal of fixed assets account with the difference between the original cost of the old punch press and accumulated depreciation on it plus its sale price.

## PROBLEM 4

*Final Examination, October 1954*

**Accounting III, Question 4 (20 marks)**

The X Co Ltd. had operated successfully for many years but has sustained substantial losses over the past five years. It has not only failed to pay any dividends over this period but the losses have exceeded the surplus accumulated on prior years' operations.

In order to liquidate their dividend liability, to reorganize the financial set up of the company and to secure funds to renovate the plant, the directors of the company propose to submit the following reorganization plan to the bondholders and shareholders for approval:

(i) The authorized capital of the company is to be changed to 12,000 5% cumulative preferred shares par value $100 each and 100,000 no par value common shares.

(ii) The holders of 7% mortgage bonds will receive $100 in new 5½% 20 year debentures at par, dated 31st December 1953, payable in equal annual instalments, and ¼ share of new 5% cumulative preferred shares and 1 new common share for each $100 bond presently held.

(iii) The arrears of cumulative preferred dividends will be liquidated by the issue of ½ new 5% cumulative preferred share and 4 new common shares for each $100 of preferred dividends in arrears.

(iv) The 6% cumulative preferred shareholders will receive 1 new 5% cumulative preferred share together with 2 new common shares for each 6% cumulative preferred share presently held.

(v) The common shareholders will receive 2½ new common shares for each common share presently held.

(vi) The new common shares issued in (ii), (iii), (iv) and (v) above are to be valued at $12.50 each.

(vii) The remaining authorized shares ares to be issued for cash to a syndicate; the preferred shares at 98 and the common shares at $11.00 each.

(viii) Any reduction in share capital is to be used to write off the deficit, goodwill and to reduce the recorded value of the fixed assets in that order.

The following is a condensed balance sheet of the X Co. Ltd. as at 31st December 1953 before the reorganization.

**X CO. LTD**

BALANCE SHEET

**as at 31st December 1953**

ASSETS

| | |
|---|---|
| Net current assets | $ 900,000 |
| Fixed assets – net | 1,300,000 |
| Goodwill | 100,000 |
| | $2,300,000 |

LIABILITIES AND CAPITAL

| | | |
|---|---|---|
| 7% mortgage bonds due 1st January 1963 | | $ 500,000 |
| Shareholders equity | | |
| Capital stock – authorized and issued | | |
| 7,500–6% cumulative preferred shares of $100 par value | $ 750,000 | |
| 12,500–common shares of $100 each | 1,250,000 | |
| | 2,000,000 | |
| Less deficit accumulated from operations | 200,000 | 1,800,000 |
| | | $2,300,000 |

Arrears of preferred dividends as at 31st December 1953 are $225,000.

**Required:**

(8 marks) (a) Journal entries, complete with narratives, to give effect to the proposed reorganization and stock issues.

(5 marks) (b) Balance sheet of X Co. Ltd. as at 31st December 1953, upon completion of the reorganization assuming that the above transactions take place as of that date.

(7 marks) (c) List the considerations that each of the following would take into account in deciding whether or not to approve the suggested reorganization:
- (i) bondholders,
- (ii) preferred shareholders, and
- (iii) common shareholders.

## A SOLUTION

### Books of X Co. Ltd.

(a)

| | | Dr. | Cr. |
|---|---|---|---|
| 1953 | | | |
| Dec. 31 | 7% Mortgage bonds payable | 500,000 | |
| | Reorganization adjustment | 187,500 | |
| | 5½% Debentures payable | | 500,000 |
| | Share capital common | | 62,500 |
| | Share capital preferred | | 125,000 |
| | To record settlement with holders of 7% mortgage bonds: $100 new 5½% 20-year debentures and ¼ share of new 5% cumulative preferred shares and 1 new common share for each $100 bond presently held, viz.,<br>5,000 new bonds of $100 each<br>1,250 new preferred shares of $100 each<br>5,000 new common shares, n.p.v valued at $12.50 each. | | |
| Dec. 31 | Reorganization adjustment | 225,000 | |
| | Share capital common | | 112,500 |
| | Share capital preferred | | 112,500 |
| | To record issue of shares to preferred shareholders in lieu of cumulative dividends: ½ new 5% preferred share and 4 new common shares for each $100 of dividends outstanding, viz,<br>9,000 new common shares, n.p.v, valued at $12.50 each<br>1,125 new preferred shares of $100 each. | | |

| | | | |
|---|---|---|---|
| Dec. 31 | 6% Preferred share capital | 750,000 | |
| | Reorganization adjustment | 187,500 | |
| | Share capital preferred | | 750,000 |
| | Share capital common | | 187,500 |
| | To record cancellation of old, and issue of new shares to holders of 6% cumulative preferred shares: 1 new 5% cumulative preferred share and 2 new common shares for each 6% cumulative preferred share, viz., 7,500 new preferred shares of $100 each 15,000 new common shares, n.p.v. valued at $12.50 each. | | |

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| | | | |
|---|---|---|---|
| Dec. 31 | Common share capital ($100 par value) | 1,250,000 | |
| | Share capital common | | 390,625 |
| | Reorganization adjustment | | 859,375 |
| | To record cancellation of old, and issue of new shares to holders of old common shares: 2½ new common shares for each common share presently held, viz, 31,250 common shares, n.p.v., valued at $12.50 each. | | |

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| | | | |
|---|---|---|---|
| Dec. 31 | Bank | 645,500 | |
| | Commission on preferred shares | 4,250 | |
| | Share capital preferred | | 212,500 |
| | Share capital common | | 437,250 |
| | To record issue of shares to syndicate: 2,125 5% cumulative preferred @ 98 39,750 common, no par value @ 11 | | |

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| | | | |
|---|---|---|---|
| Dec. 31 | Reorganization adjustment | 259,375 | |
| | Deficit | | 200,000 |
| | Goodwill | | 55,125 |
| | Commission on preferred shares | | 4,250 |
| | To record the application of the reduction in the capital stock in the hands of the old shareholders in the way of writing off the deficit, the commission on the issue of preferred shares, and part of the goodwill. | | |

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(b)

## X CO. LTD

### Balance Sheet As At Dec 1953

**After giving effect to proposed reorganization — see note 1 below**

### ASSETS

| | |
|---|---|
| Net current assets | $1,545,500 |
| Fixed assets, net after recorded depreciation to date | 1,300,000 |
| Goodwill | 44,875 |
| | $2,890,375 |

LIABILITIES AND SHAREHOLDERS EQUITY

| | | |
|---|---|---|
| ***Long term liability*** | | |
| 5½% 20 year debentures due 1 Dec 1973, payable in equal annual instalments | | $ 500,000 |
| ***Shareholders equity*** | | |
| Share capital | | |
| Preferred — authorized and issued 12,000 5% cumulative preferred shares of $100 each (see note 2) | $1,200,000 | |
| Common — authorized and issued, 100,000 common shares no par value (see note 3) | 1,190,375 | |
| Total shareholders equity | | 2,390,375 |
| | | $2,890,375 |

Note 1. The plan of reorganization is as follows:
(details)

| | | |
|---|---|---|
| Note 2. | 2,125 preferred shares issued for cash | $ 212,500 |
| | 9,875 preferred shares issued to bondholders and shareholders in reorganization plan | 987,500 |
| | | $1,200,000 |
| Note 3. | 39,750 common shares issued for cash | 437,250 |
| | 960,250 common shares issued to bondholders and shareholders in reorganization plan | 753,125 |
| | | $1,190,375 |

*Editor's note*: The commission on preferred shares need not have been written off, in which case the balance sheet would show goodwill as $40,625, and another asset, commission on preferred shares, as $4,250.

### (c) Considerations to be taken into account by the groups affected

(i) The bondholders will have to accept a reduction in interest income and a longer term. This sacrifice may be compensated for, however, by the bonus shares they receive, because these shares will be of value if the company prospers in the future.

(ii) The preferred shareholders will have achieved an increase in equity through the issue of additional common shares to them, and they may therefore recoup the reduction in their preference as to dividends (from 6% to 5%) if the company prospers in the future.

(iii) The common shareholders are being asked to make a substantial sacrifice in their equity. Their only incentive for accepting the plan is that it will bring additional working capital into the company and will reduce the bond interest charges, so that the company may operate more profitably in the future. The common shareholders might be well advised to explore the possibility of securing somewhat better terms for themselves.

BY PETER C. BRIANT, B.COM., C.A.

*Assistant Professor, McGill University*

# *Current Reading*

## MAGAZINE ARTICLES

### ACCOUNTING

"SECURITY ANALYSTS AND THE PRICE LEVEL" by Charles T. Horngren. *The Accounting Review,* October 1955, pp. 575-581.

> ". . . It is time that the funds statement be recognized as a valuable part of the financial reporting family. Such a statement, drafted with full cognizance of its uses and limitations, might aid considerably in solving some vexing analytical problems. It might serve much better than price level adjustments to fulfill the needs and wants of those who *use* the data that accountants are expected to supply in financial reports . . . "

The above financial statement, pregnant with implications for accounting research, is the outcome of an extensive survey of literature on investment analysis, the scrutiny of 123 written analytical reports, and the collection of the opinions of 51 security analysts. According to Mr. Horngren, these gentlemen are primarily concerned with flows, and consequently find the income statement and the funds statement to be of more use to them than the balance sheet. Significantly, not one analyst who was interviewed attempts to adjust the statements for price level changes, and all are united in their stand against such adjustment.

Mr. Horngren points to the analysts' somewhat unconventional treatment of depreciation as the clue to understanding their attitude towards price level adjustments. Apparently, they regard income as the excess of current revenues over current expenses, excluding depreciation. A part of this difference is then treated as a recovery of past fixed asset outlays, and is intended to be applied to the repayment of long-term debt arising from prior capital expenditures or to new expenditures on plant and equipment. Depreciation is considered to be inadequate if the price level has changed so substantially that the amounts charged are insufficient to meet capital replacement demands.

Mr. Horngren maintains that attempts to adjust statements for changed price levels would merely offer "a fuzzy concept in place of a workable, useful and significant concept". Most accountants will probably feel, however, that treating depreciation as the portion of the cash inflow that should be earmarked for capital expenditure or debt repayment is itself the fuzzy concept that needs to be replaced. When security analysts have such an unconventional notion of depreciation it is difficult to agree with Mr. Horngren that "research in accountancy with respect to the serving of investors should give greater heed to the analyst and should give weight to his position in setting standards for financial reporting . . . "

"Conservation of Productive Capital Through Recognition of Current Cost of Depreciation" by Paul Grady. *The Accounting Review*, October 1955, pp. 617-622.

In an address at the annual meeting of the Manufacturing Chemists Association, Mr. Grady cites some significant figures developed by George Terborgh to indicate the extent to which price inflation has distorted financial statements:

> ". . . a reasonable estimate of the extent to which the cost of depreciable productive plant facilities in current dollars exceeds historical dollar costs . . . is seventy billion dollars and the portion thereof applicable to a current year is estimated at about four and one-half billions. This seventy billion of current dollar cost of productive plant . . . is about 35% of the total investment in depreciable industrial plant facilities in America. It is four times the annual reported earnings of all corporations for 1953 and five times those annual earnings if depreciation were adjusted to current dollars . . . it is ten billion more than the total current value of all recorded gold production in the world since the discovery of America. . . ."

Mr. Grady warns those industrialists whose plants are mainly post-war acquisitions, that more than two-thirds of the loss in purchasing power of the dollar has occurred in the post-war period.

**MARKETING**

"Control of Marketing Costs" by Arthur P. Felton. *Cost and Management*, November 1955, pp. 375-380.

Contending that profit margins will once again be squeezed between lower sales prices and higher marketing costs, Mr. Felton urges manufacturers to appraise their sales management programs against the latest market and industry trends, and to undertake a study of their distribution costs to determine the area of unprofitable sales.

The appraisal of the sales management program does not normally fall within the province of the accountant, but the analysis of distribution costs is an area in which the accountant can make a significant contribution. Mr. Felton asserts, however, that while most companies have a detailed break down of sales volume figures, few have reliable costs for the individual units that make up the volume. He cites, for example, the case of one company, selling two products priced at $200 and $600, that allocated freight costs on the basis of relative sales value. It was subsequently determined that the freight-rates on the two items were the same. Correct costing revealed, therefore, that it was unprofitable to ship the cheaper product into distant territories, while the higher-priced product had a greater profit potential than realized.

Another company found that 68% of its accounts brought in only 10% of the business. Dropping these accounts resulted in a 50% reduction in marketing costs and a 76% increase in sales through a redirection of the sales effort.

A territorial cost analysis of a third company indicated 28% of the number of towns covered were unprofitable. By eliminating or curtailing service to these towns, the company was able to reduce its sales force by 40% and doubled its sales in profitable areas.

These examples should be sufficient to illustrate what can be achieved in the area of distribution cost analysis. Cooperation between the sales personnel and the accounting department should result in increased volume at lower marketing costs with a corresponding increase in company profits.

## BOOK REVIEWS

**The Interpretation of Financial Statements, by Benjamin Graham and Charles McGorlick; Harper and Brothers, Publishers: New York, 1955 (revised) pp. viii, 114; $3.50.**

In the preface, the authors observe that "When you know what the figures mean, you have a sound basis for good business judgment." The purpose of this book is to provide a means whereby the non-accountant may acquire some knowledge of what the figures mean. Thus, the objective is a limited one; no pretence is made that the reader might acquire a complete understanding of financial statements or be in a position to interpret financial statements with some degree of refinement. It seems important to place some stress on this rather limited objective of the authors in order to make a fair appraisal of their efforts. For example, it probably would be unfair to assert that the treatment of statement analysis is too brief, because such an assertion would not give proper allowance to the authors' limited objectives.

However, the brevity of treatment is an important feature of the book. The 33 chapters in Part I, covering the meaning of financial statements, require the equivalent of about 60 pages only (the majority of the chapters are one or two pages long), and the pages are small, measuring 7¼" by 5". A brief outline of the basic bookkeeping methods (Part II) is covered in four pages. Assuming that the reader needs some exposure to basic bookkeeping, many accountants might hold some reservations as to whether much can be achieved toward alleviating such deficiency in four pages. Part III is an illustrative exercise in ratio analysis applied to the financial statements of Bethlehem Steel Corporation. Part IV is devoted to definitions of financial terms and phrases.

The authors do an excellent job of explaining accounting terminology, mentioning most of the synonymous phrases appearing in published statements. Occasionally, small objections can be raised. For instance, current assets are defined from a time-period point of view, rather than an operating-cycle approach. Some accountants might question the statement, "The *Lifo* method was introduced about 1941 in order to avoid marking up inventories to reflect the war-induced rise in the price level." (p. 25) And depreciation is described on page 31 by using words such as "a gradual loss of value through age and use" and "the ordinary wearing out of buildings and equipment". But later, on page 94, better words are used: "Depreciation Reserve. The valuation reflecting the total book depreciation to date, and therefore indicating the expired portion of the useful life, of the assets to which it pertains. A depreciation reserve of $200,000 against a $1,000,000 asset indicates, not that the asset's present resale value is $800,000, but rather that about 20% of the asset's useful life is believed to have expired."

A number of suggestions the authors make regarding financial state-

ments deserve consideration by the accounting profession. The following are examples: "We suggest that if the insured value of the plant and property were given as a footnote to the balance sheet, a much more informing picture of the plant account would be available to those who really own the assets." (p. 29) "We think the pendulum has swung too far in the direction of ignoring balance sheet values. The property account should neither be accepted at face amount nor overlooked entirely. It deserves reasonable consideration in appraising the company's securities." (p. 30)

There is considerable evidence throughout the book that potential investors can learn a great deal of sound investment philosophy from the authors. The following quotation, though brief, is typical: "At bottom, the ability to buy securities—particularly common stocks—successfully is the ability to look ahead accurately. Looking backward, however carefully, will not suffice, and may do more harm than good." (p. 69)

HERBERT E. MILLER, Ph.D., C.P.A.

**The Theory of Inventory Management, by T. M. Whitin. Princeton: Princeton University Press, 1953; pp. viii, 245; $4.50.**

Professor Whitin has written a decidedly different kind of book on inventory control. The essential theory of rational inventory control is handled in a relatively brief compass (pp. 15-78) and is then extended to an analysis of the theory of the firm, business cycle theory, and military planning. This is not a book on "how to do it," but rather on "what to do" and the overall framework of analysis.

In the first part, Whitin concentrates on the economical determination of purchase quantities and the statistical determination of safety allowances. The economic purchase quantity is that quantity which balances two sets of cost factors. One set increases with the level of inventories: interest, obsolescence, spoilage, storage, risk, etc. The other set decreases as inventories increase: procurement costs, quantity discounts, freight differentials, etc. First, Whitin develops the simplest economic purchase quantity formula, an old friend to students of management since 1915. This formula states that the desired purchase quantity varies directly with the square root of expected sales and the square root of procurement expenses and varies inversely with the square root of carrying charges. The analysis is then extended to cover quantity discounts, variable storage costs and price anticipations.

One of the merits of Whitin's treatment is his handling of uncertainty and, therefore, safety allowances. The costliness of fixed safety allowances is demonstrated. The optimum safety allowance is "one for which the probability of depletion balances expected costs of depletion and carrying charges for the marginal unit." It is shown that it is unwise to hold safety allowances so large that stocks never run out. Most of this analysis is in terms of non-style goods. Whitin also takes up the case of style goods. Here ordering costs and carrying charges are not too important. The problem is basically one of losses on surplus merchandise if too large inventories are stocked and losses of profits if inadequate inventories are stocked. This section involves probability analysis but ex-

amples are included for the non-mathematically inclined reader which serve to illustrate the nature of the maximization process.

The second part of the book adds little new to the controversy over the role of inventories in business fluctuations. Whitin believes his analysis of rational inventory control helps distinguish between planned and unplanned inventories in the theory of inventory cycles and also helps explain the asymmetrical behaviour of inventory investment over the cycle. The section concludes with a discussion of inventories in general equilibrium models and will be of interest to economists familiar with the Leontief, von Neumann, and Air Force models.

The last section includes an interesting discussion of the problem of inventory control in the military establishment and provides an illustration of game theory in an attempt to clarify the problem of military value. Except for further extension of principles applicable to private firms, improved inventory control in the military establishment awaits a more scientific framework for dealing with complex variables such as strategy, technology, and military worth. At present we lack a theory which is adequate to cope with the magnitude of the military problem in any practical way. But much research is now being carried on in this area though little publicity has been given to it. In a book which attempts to be brief yet extensive in scope, some topics are bound to be treated in too compressed a manner. Fortunately, an unusually comprehensive bibliography is appended. Many of the items are from trade journals.

JEROME SNYDER

## SELECTED READING

**Financial and Administrative Accounting, by C. Aubrey Smith and Jim G. Ashburne. McGraw-Hill Book Co., pp. x, 493; $8.50**

This book is written expressly for the *user* of accounting data rather than the *producer*.

**Raising Capital with Convertible Securities, by C. James Pelcher. School of Business Administration, University of Michigan, pp. 153; $2.50**

The role of convertible bonds and preferred stocks as capital-raising instruments is analyzed and evaluated.

**Report Writing for Accountants, by Jennie M. Palen. Prentice-Hall Inc., pp. xii, 602; $9.25**

This how-to-do-it introduction to effective report writing explains exactly how to prepare and report on financial statements.

**Handbook for Secretaries to Accountants, Controllers, Treasurers, by Bessie May Miller. Prentice-Hall, Inc., pp. xvii, 438; $8.95**

Offers work-saving techniques on every accounting office task from routine assignments to assisting the accountant, controller or treasurer with technical reports and tax matters.

**Catalogue of the Glasgow Library. The Institute of Chartered Accountants of Scotland, pp. 372; 10/-**

A complete catalogue of the more than 15,000 volumes in a well known professional library.

**Taxation Manual, by Ronald Staples. Taxation Publishing Co. Ltd., pp. xx, 441; 25/7**

Now in its eighth edition, this handbook provides a ready means of access to the interpretation and effect of the law of income tax and surtax in Britain.

**Taxation Statistics 1955, Department of National Revenue (Taxation Division), pp. 145, $1.50**

Features a section on Succession Duty statistics, which have not appeared since the 1951 edition, and also includes the regular analyses of collections, individual income tax and corporation income tax.

# NEWS OF OUR MEMBERS

***British Columbia***

H. J. Burns, C.A. has been appointed administrative assistant to the president of the Powell River Company.

***Manitoba***

W. D. Love & Co., Chartered Accountants, announce the removal of their offices to 205-206 Montreal Trust Bldg., 218 Portage Ave., Winnipeg.

***Nova Scotia***

In the December issue of this journal J. A. Manning of Truro was erroneously referred to as a "C.A.". The Council of the Nova Scotia Institute has called attention to the fact that Mr. Manning is not and never has been a chartered accountant.

***Ontario***

Horace G. Lewis, C.A. announces acquisition of the practice of the Toronto office of Wm. C. Benson & Co., Chartered Accountants, of which he was formerly a resident partner. Henceforth he will carry on practice of the profession in partnership with John J. Davie, C.A. under the firm name of Horace G. Lewis & Co., Chartered Accountants, with offices at 86 Bloor St. W., Toronto.

J. H. Collins, F.C.A. has been appointed chief accountant of the Liquor Control Board of Ontario.

Loftus A. Allen & Co., Chartered Accountants, announce the removal of their offices to 2 Toronto St., Toronto.

Albert Freedman, C.A. announces the admission to partnership of Morris Flicht, C.A. Henceforth practice of the profession will be carried on under the firm name of Freedman & Flicht, Chartered Accountants, with offices at 208 King St. W., Toronto.

Allan L. Brown, C.A. has been appointed assistant commissioner (finance) of the Penitentiaries Branch, Department of Justice, Ottawa.

Harvey L. Millman, C.A. and Kenneth C. Buckingham, B.Com., C.A. announce the formation of a partnership for the practice of their profession under the firm name of Millman & Buckingham, Chartered Accountants, with offices at 129 Princess St., Kingston.

Francis Lorenzen, C.A. and Maxwell C. Smith, C.A. announce the formation of a partnership for the practice of their profession at 1201 London St. W., Windsor, under the firm name of Francis Lorenzen & Co, Chartered Accountants.

Allan Pyzer, C.A. announces the removal of his office to Ste. 632, 67 Yong St., Toronto.

Wm. L. Walton & Co., Chartered Accountants, announce the admission to partnership of William Wagman, C.A. Henceforth practice of the profession will be carried on under the firm name of Walton, Wagman & Co., Chartered Accountants, with offices at 62 Richmond St. W., Toronto.

***Quebec***

David Finestone, C.A. announces the removal of his office to Ste. 610, 637 Craig St. W., Montreal.

C. D. Mellor, executive secretary of the Quebec Institute, addressed the Commerce students at Loyola College recently on "The Accounting Profession".

Messrs Jean-Jules Rufiange, c.a. et Fernand-E. Leblanc, c.a. désirent annoncer que M. L. J. Trottier fait maintenant partie du bureau de Rufiange, Leblanc & Cie, comptables agréés, edifice St-Sulpice, 418 rue St-Sulpice, Montréal.

# INSTITUTE NOTES

### *ONTARIO INSTITUTE NOTES*

***Presentation of Certificates Ceremony*** — Henry O. Glover, F.C.A. has kindly consented to give the "Address of Welcome" to the new members on Friday, February 10 in the place of J. G. Glassco, F.C.A., who, after accepting the invitation, was forced to withdraw on account of a business trip to South America.

***Minimum Educational Qualifications After July 1, 1956*** — The Council has approved a reduction from 9 to 8 in the number of Grade XIII papers required for registration after July 1, 1956. The requirement in Mathematics which has been three papers with at least an average of 60% has also been changed. Applicants can either submit the present requirements *or* they can offer the one paper Algebra with at least 60%. Mathematics of Investment remains an acceptable substitute for Algebra. These changes will have to be approved by the next annual meeting. They were made in recognition of the fact that the Province of Ontario gives the Honour Graduation Diploma, which is the highest secondary school certificate, for standing in 8 papers and all Ontario universities except Toronto admit students to their faculties of Arts with only 8 papers. The change in the mathematics requirement is not intended to lower the standard but to permit more flexibility in subject choice. Algebra is considered the mathematical paper essential for accountants and hence it is retained as the compulsory one.

***Economics and Law Examinations*** — On the recommendation of the Board of Instruction and the Examinations Committee the Council has changed the passing requirements in the Economics, primary Mercantile and Statute Law, and intermediate Mercantile and Statute Law examinations from 50% to 60% commencing in 1956. These examinations will now have the same passing requirement as the other examinations. It was the opinion of the Board of Instruction that the former lower passing requirements had prejudiced students against the studies in these subjects to the detriment of the instruction.

***1956 Examinations*** — The Council has accepted a recommendation of the Examinations Committee to shorten each of the primary papers and the intermediate Mercantile and Statute Law examination to three hours in 1956. This decision should be particularly welcome to the primary students who write two papers on both days of the examinations. The reduction in time will permit the examinations to start at 9:30 a.m. instead of 9:00 with an hour and a half for the luncheon break. No increase is planned in the number of papers. The 1956 examinations will be held on October 10 - 12 and 15 - 19 with the primary examinations on the last two days.

### *ONTARIO STUDENTS' ASSOCIATION NOTES*

***Next Meeting*** — The next meeting of the Toronto members will be on Tuesday, February 14, 1956 at 8:00 p.m. in the Lecture Hall of the C.A. Building. The speaker will be Norman W. Wardell of Hunter, Rowell & Co. Ltd., Insurance Agents. He will talk on a typical insurance survey, and analysis of requirements, for a business operation.

***The editor welcomes information for this column. News of members and provincial Institutes' activities should be received by the 14th of the month to appear in the following issue of the journal.***

# CLASSIFIED ADVERTISEMENTS

**Rates:** ***Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate $17.00 per column inch.***
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APPLICATIONS are invited for the position of Treasurer of the City of Kingston. Applicants having advanced experience in accounting work or with a C.A. degree are preferred. Experience in municipal work is desirable but not essential. Please submit your application outlining your qualifications to: T. J. McKibbin, Clerk-Comptroller, City Hall, Kingston, Ontario.

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